SECTION 6000

SPECIALIZED ACCOUNTING

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6000 SPECIALIZED ACCOUNTING

Federal credit union financial transactions have become increasingly more diverse and complex because of a larger variety of services offered, expanded authorities in a deregulated environment, mergers of credit unions, and growth in their fields of membership. Many federal credit unions have expanded their services through programs such as mortgage and commercial lending, share drafts or credit cards, or involved in activities such as establishing a branch operation has been increasing. This section of the accounting manual is therefore intended for all those federal credit unions in need of these additional guidelines in specialized accounting areas.

6010 LENDING ACTIVITIES

This section sets forth the regulatory accounting requirements for Federal credit unions in accounting for nonrefundable fees and costs associated with originating and acquiring loans. Originating and acquiring loans includes lending, committing to lend, or purchasing a loan or group of loans.

This section applies to all types of loans extended by credit unions: consumer loans, mortgage loans, commercial and agricultural loans.

The policy set forth in this section is an exception to generally accepted accounting principles as to credit unions using the modified cash basis of accounting.

6010.1 NONREFUNDABLE LOAN ORIGINATION FEES AND COSTS

Credit unions following a modified cash basis of accounting may apply, at their option, the rules set forth in Section 6010.1.2 below for credit unions using the full accrual basis of accounting or they are required, at a minimum, to amortize loan origination fees over the life of the loan or ten years, whichever period is shorter (see Section 6010.1.1).

Credit unions following the full accrual basis of accounting should fury adopt the provisions set forth in 6010.1.2 below. The section requires that:

- Loan origination fees be recognized over the life of the related loan as adjustment of yield.
- Direct loan origination costs be recognized over the life of the related loan as a reduction of the loan's yield.
- Loan commitment fees be deferred except for certain specified fees.
- The adjustment of yield generally be by the interest method.

6010.1.1 UNDER THE MODIFIED CASH BASIS

Credit unions using a modified cash basis of accounting may or may not apply the provisions of Section 6010.1.2, at their option. If a credit union chooses not to follow Section 6010.1.2, they are required, at a minimum, to amortized loan fees over 10 years or the life of the loan, whichever period is shorter. The deferral of income recognition and the method of amortization should be as discussed below for credit unions using the full accrual basis of accounting.

6010.1.2 UNDER THE FULL ACCRUAL BASIS

The application of the provisions of this section is clearly not required where reporting differences between application and nonapplication of these provisions are not material. The main area of applicability for federal credit unions is expected to be in the areas of real estate and commercial lending.

The provisions of this section were established by the Financial Accounting Standards Board (FASB) in Statement of Financial Accounting Standard (SFAS) No. 91 (copies available through the FASB). Federal credit unions should seek the assistance of an independent accountant if they do not have the expertise to implement SFAS No. 91.

6010.2 LOAN ORIGINATION FEES

Loan origination fees charged a member and the related direct loan origination costs incurred for a given loan should be offset and the net amount deferred and recognized over the life of the loan as an adjustment of yield using the interest method. The netting of fees and costs should be applied on an individual loan basis although aggregation of similar loans is permissible under certain conditions. The practice of recognizing loan origination fees as income in the period earned/received and expensing related costs when incurred or in the period the loan is granted is no longer acceptable. The objective of the interest method is to arrive at periodic interest income at a constant effective yield on the net investment (carrying value).

Examples of the types of loan origination costs a federal credit union should defer include costs related to evaluating the prospective borrower's financial condition; evaluating and recording guarantees, collateral and other such arrangements, negotiating loan terms, preparing and processing loan documents and closing the transaction. The federal credit union should only defer that portion of the employee's total compensation and payroll related fringe benefits directly related to time spent performing those activities for that loan and other related costs that would not have been incurred but for that loan.

All other lending related costs, including costs related to activities performed by the lender for advertising, soliciting potential borrowers, servicing existing loans, and other ancillary activities related to establishing and monitoring credit policies, supervision, and administration, should be charged to expense as incurred. Employees' compensation and fringe benefits related to those activities, unsuccessful loan origination efforts, and idle time should be charged to expense as incurred. Administrative costs, rent, depreciation, and all other occupancy and equipment costs are considered indirect costs and should be charged to expense as incurred.

Amounts of loan origination, commitment and other fees and costs recognized as an adjustment of yield should be reported as part of interest income. The unamortized balance of loan origination, commitment and other fees and costs recognized as an adjustment of yield should be reported on the federal credit union's balance sheet as part of the loan balance to which it relates.

6010.3 COMMITMENT FEES

Generally, fees received for a commitment to originate or purchase a loan or a group of loans should be offset with direct loan origination costs to make a commitment and deferred. If the commitment is exercised, the net fees should be recognized over the life of the loan as an adjustment of yield or, if the commitment expires unexercised, recognized in income upon expiration of the commitment. If the likelihood that the commitment will be exercised is remote, the commitment fee should be recognized over the commitment period on a straight-line b is as service fee income. If the commitment is subsequently exercised during the commitment period, the remaining unamortized commitment fee at the time of exercise should be recognized over the life of the loan as an adjustment of yield.

If material, fees that are periodically charged to cardholders should be deferred and recognized on a straight-line basis over the period the fee entitles the cardholder (member) to use the card.

6010.4 DEMAND LOANS

For a loan that is payable at the lender's demand, any net fees or costs may be recognized as an adjustment of yield on a straight-line basis over a period that is consistent with (1) the understanding between the borrower and lender or (2) if no understanding exists, the lender's estimate of the period of time over which the loan will remain outstanding. Any unamortized amount should be recognized when the loan is paid in full.

6010.5 REVOLVING LINES OF CREDIT

For revolving lines of credit (or such loan arrangements), the net fees or costs should be recognized in income on a straight-line basis over the period the revolving line of credit is active, assuming that borrowings are outstanding for the maximum term provided in the loan contract. If the borrower pays all borrowings and cannot borrow again under the contract, any unamortized net fees or costs should be recognized in income upon payment. The interest method should be applied to recognize not unamortized fees or costs when the loan agreement provides a schedule for payment and no additional borrowings are provided for under the agreement.

6010.6 PURCHASE OF A LOAN OR GROUP OF LOANS

The initial investment in a purchased loan or group of loans should include the amount paid to the seller plus any fees paid or less any fees received. The initial investment frequently differs from the related loan's principal amount at the date of purchase. This difference should be recognized as an adjustment of yield over the life of the loan. All other costs incurred in connection with acquiring purchased loans or committing to purchase loans should be charged to expense as incurred.

The purchaser may allocate the initial investment to the individual loans or may account for the initial investment in the aggregate. The cost flows provided by the underlying loan contracts should be used to apply the interest method. If prepayments are not anticipated and prepayments occur or a portion of the purchased loans are sold, a proportionate amount of the related deferred fees and purchase premium or discount should be recognized in income so that the effective interest rate on the remaining portion of loans continues unchanged.

6010.7 AGGREGATION OF SIMILAR LOANS

If the federal credit union holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the federal credit union may consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method.

If the federal credit union anticipates prepayments in applying the interest method and a difference arises between the prepayments anticipated and actual prepayments received, the federal credit union should calculate the effective yield to reflect actual payments to date and anticipated future payments. The net investment in the loans should be adjusted to the amount that would have existed had the new effective yield been applied since the acquisition of the loans. The investment in the loans should be adjusted to the new balance with a corresponding charge or credit to interest income.

Federal credit unions that anticipate prepayments should disclose that policy and significant assumptions underlying the prepayment estimates. The practice of recognizing net fees over the estimated average life of a group of loans is no longer acceptable.

6010.8 DEFINITIONS

Commitment Fees. Fees charged for entering into an agreement that obligates the Federal credit union to make or acquire a loan or satisfy an obligation of the other party under a specified condition. Commitment fees include fees for letters of credit and obligations to purchase a loan or group of loans and pass-through certificates.

Credit Card Fees. The periodic uniform fees that entitle cardholders to use credit cards including fees received in similar arrangements, such as charge card and cash card fees.

Incremental Direct Costs. Costs to originate a loan that (1) result directly from and are essential to the lending transaction and (2) would not have been incurred by the lender had the lending transaction not occurred.

Lending Activities. Lending, committing to lend, refinancing or restructuring loans, arranging standby letters of credit, syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

Origination Fees. Fees charged to the borrower in connection with the process of originating, refinancing, or restructuring a loan including points, management, arrangement, placement, application, underwriting and also syndication and participation fees to the extent they are associated with the portion of the loan retained by the lender.

6010.9 ACCOUNTING ENTRIES AND THE INTEREST METHOD

The Illustrative Entries on pages 4-51 through 4-53 of Section 4050.4, Account No. 703.1, give a good example of the accounting entries for a loan and the corresponding amortization/accretion using the interest method. We have not repeated the illustration here but refer you to that section of the manual.

6020 ACCOUNTING GUIDELINES FOR REAL ESTATE LENDING

6020.1 GENERAL

The provisions of Section 107 of the Federal Credit Union Act, and Section 701.21 of the NCUA Rules and Regulations, allows federal credit unions to make loans with maturities up to 40 years on residential real property. The regulation contains certain restrictions on the types of property which can be financed, prescribes various forms, limits, and discusses due on-sale clauses.

The degree of risk in a real estate loan depends on the amount loaned, interest rate, value of the property, ability of the borrower to repay, local economic climate, and other special terms.

The effective rate of interest, inclusive of all finance charges is limited by the Rules and Regulations. In the event of early repayment of any real estate loan where finance charges are assessed, a recomputation is required and a refund must be made if the sum of the interest paid plus the finance charges paid exceeds the maximum permitted by the Rules and Regulations. The liability and responsibility to refund such excess finance charges remains with the FCU in the event the loan is sold, unless the contract specifically provides that the responsibility flows to any subsequent purchase of the obligation. (See Section 6020.4 for a discussion of the Recomputation for Rebate.)

6020.1.1 TYPES OF REAL ESTATE MORTGAGE LOANS

Fixed Rate Mortgage Loans

Fixed rate mortgage loans refer to loans that have maturities from 12 years on up to and including 40 years and interest rates that remain the same from the time of their origination. Such loans are rated to the finance or refinancing of a one-to-four family dwelling, including an individual cooperative unit, which will be used for the principal residence of the federal credit union member.

Variable Rate Mortgage Loans

Variable rate loans are tied to an index agreed upon by the borrower and the credit union. The board of directors establishes the variable rate mortgage loan's lending policies as it deems appropriate. The policies must be in writing and consistent with cooperative principles and existing laws and regulations. Variable rate loans provide an effective method for the credit union to pass on to the borrower the risk of increases in the market interest rates for loans. Movement in the index results in an increase or decrease in the interest rate which is implemented through changes in the monthly payment, changes in the loan maturity, or through a combination of these methods. In the case of a long-term real estate loan, the credit union is prohibited from using its own funds as an index. If the principal interest rate is adjusted, the payment of the loan must be adjusted at least every five years to an amount sufficient to fully amortize the loan at maturity. If the adjustment in the interest rate is implemented through an extension of the maturity, the adjustment may not cause the maturity to exceed 40 years.

From a funds management point of view, a credit union's own costs of funds would be an ideal index. There is concern, however, over the ability of a credit union to enforce a contract in which the key terms are uncertain or not definable. The following are some of the more common indices:

a) The average contract interest rate charged by all lenders on mortgage loans for previously occupied homes as published by the Federal Home Loan Bank Board in its Journal.

b) The average monthly yield on 26 week United States Treasury securities as published in the *Federal Reserve Bulletin.*

c) The average monthly yield on the United States Treasury Securities adjusted to a constant maturity of 3 years based on the daily closing bid prices as published in the *Federal Reserve Bulletin.*

d) The average monthly yield on the United States Treasury securities adjusted to a constant maturity of 5 years based on daily closing bid prices as published in the *Federal Reserve Bulletin*

e) The average of "prime lending rate" as published by specific banks or newspapers.

A variable rate loan to a person on a fixed income could cause the borrower and the credit union problems since the individual may not be able to afford unanticipated increase in the monthly payment. Additionally, when the variable rate loans are adjusted through addition of unpaid interest to the principal balance, the result may be that large final payments are required. This is potentially risky and dangerous to liquidity, earnings, depreciated collateral, and default in the same ways as would occur in balloon type loans. The credit union is required to prepare disclosures for variable rate loans according to Regulation Z. Members should be provided with "worst case" situations so they will fully understand the potential problems which could occur due to rate changes.

Participation Mortgage Loans

A participation loan is a loan that is made in participation with one or more eligible organization where the written commitment to participate in the loan precedes final disbursement. Section 701.22 of the NCUA Rules and Regulations contains additional information. A federal credit union's interest in a participation loan may not exceed 10 percent of its unimpaired capital and surplus.

Secondary Market

One method in which a federal credit union can serve the home financing needs of its members is through the secondary market. The secondary market refers to investors who purchase mortgage loans either for their own portfolio or for the assembly of mortgage backed securities. This would include Federal National Mortgage Association, Federal Home Loan Mortgage Corporation, and Government National Mortgage Association. The secondary market also includes insurance companies, pension funds, mutual savings banks, savings and loan associations, and private investors. Under the secondary market arrangement, the credit union would obtain a commitment from an investor to purchase mortgage loans. The credit unions would then originate mortgage loans according to specifications of the investor, sell the closed mortgage loans to the investor and service the loans for the investor. Servicing involves four major operations:

a) Processing of payments. The net proceeds after retaining taxes, mortgage insurance, hazard insurance, and servicing fees are remitted to the investor. The servicer is expected to handle escrow accounts and to pay taxes and insurance premiums when due.

b) Protection of security. The servicer is expected to periodically inspect the property to make sure it is not being subjected to waste or unusual depreciation.

c) Recordation. When the property changes hands and a new owner assumes the mortgage, a whole series of records must be changed and recorded. In the case of a mortgage insured by the Federal Housing Authority or guaranteed by the Veterans Administration, the proper government agency must be notified and required government forms must be completed.

d) Collection. The servicer is expected to take all collection steps including foreclosures if necessary.

A due-on-sale clause, a type of acceleration clause, gives the credit union the option of calling the loan if the borrower sells or transfers all or part of his or her interest in the property securing the loan. The Federal National Mortgage Association and Federal Home Loan Mortgage Corporation uniform instruments contain the clause. These instruments will facilitate the credit union's entrance into the secondary mortgage market in the event that the loans must be sold.

6020.2 AFFECTED ACCOUNTS

The following are the account numbers and the account titles which will be used by FCUs engaged in real estate lending.

114	Interest of Real Estate Loans
140	Gain (Loss) on Sale of Loans and Other Eligible Obligations
285	Refunds - Real Estate Finance Charges
303	Provision for Loan Losses - Real Estate Loans
703	Real Estate Loans Over 12 Years
703.1	Net Origination Fees (Costs) - Real Estate Loans Over 12 Years
704	Real Estate Loans - 12 Years or Less

704.1	Net Origination Fees (Costs) - Real Estate Loans - 12 Years or Less
719	Allowance for Loan Losses
728	Real Estate Loans Receivable
784	Accrued Interest on Real Estate Loans
808	Real Estate Loans Payable
809	Escrow Accounts
885	Deferred Credits - Prepaid Interest - Real Estate Loans
905	Shares - Escrow Accounts

Account descriptions for the above accounts can be found in the applicable subsections of Section 4000, General Ledger of Accounts, by the account number referenced.

6020.3 SAMPLE ACCOUNTING ENTRIES

To show the interrelation of the various accounts involved in a real estate loan, the following example will be used. The figures shown on the HUD-1 Settlement Statement are used to demonstrate the accounting entries required when the loan is granted and the recomputation which is required when the loan is paid off early. Accounting entries are shown for two different situations. In the first example it is assumed that an attorney performs the closing and handles the disbursement of funds. In the second example it is assumed that the credit union performs the closing and handles the disbursement of all funds. The same Settlement Statement is used for both examples.

Example #1

Assumptions:

a) Attorney, Harry Settlor, handles the closing and makes all disbursements with the exception of the appraisal fee.

b) The FCU retains the appraiser and disburses the appraisal fee after settlement.

c) The FCU's check for the loan proceeds is make payable to the attorney (Harry Settlor) for distribution at settlement.

d) All disbursements (those of the FCU and the attorney) except for the appraisal fee are made on the date of closing, 8/12/XX.

e) Escrow accounts are required for Real Estate loans.

Under these assumptions Harry Settlor would receive $58,000 for the FCU and $8,955.66 from the buyer. These funds would then be disbursed by Harry Settlor to the seller, the previous mortgage holder and to pay various other costs.

Entries in FCU's Records:

a) To record the disbursement of loan proceeds to the settlement agency of the Byer's loan:

Dr. - Real Estate Loans Over
12 Years (Acct. No. 703.1) $58,000
Cr. - Cash (Acct. No. 731) $58,000

b) To record receipt of funds from settlement agency as reimbursement for payment of appraisal fee on the Sellar's property (Byer's loan):

Dr. - Cash (Acct. No. 731) $265
Cr. - Real Estate Loans Payable
(Acct. No. 808) $265

c) To record receipt of funds from settlement agent for borrower's points:

Dr. - Cash (Acct. No. 731) $580
Cr.-Net Origination Fees (Costs)-
Real Estate Loans Over 12 Years
(Acct. No. 703.1) $580

d) To record receipt of funds from settlement agent for loan discount Cellar-Byer Transaction:

Dr. - Cash (Acct. No. 731) $580
Cr.-Net Origination Fees (Costs)-
Real Estate Loans Over 12 Years
(Acct. No. 703.1) $580

e) To record receipt of funds from settlement agent for loan origination fee:

Dr. - Cash (Acct. No. 731) $580
Cr.-Net Origination Fees (Costs)-
Real Estate Loans Over 12 Years
(Acct. No. 703.1) $580

f) To record receipt of funds from settlement agent for 19 days prepaid interest on Byer's loan:

Dr. - Cash (Acct. No. 731) $275.50
Cr.-Net Origination Fees (Costs)-
Real Estate Loans Over 12 Years
(Acct. No. 703.1) $275.50

g) To record receipt of funds from settlement agent for reserves on Byer's loan (Hazard Ins. $22.00, Mortgage Ins. $24.16, and Property Tax $321.40):

Dr. - Cash (Acct. No. 731) $367.56
Cr.-Shares - Escrow
(Acct. No. 905) $367.56

h) To record the payment of the Real Estate appraisal fee on the Cellar's property:

Dr. - Accounts Payable-Real Estate
Loans (Acct. No. 808) $265
Cr.-Cash (Acct. No. 731) $265

Example #2

Assumptions:

a) The FCU handles the closing and makes all disbursements.

b) The FCU has retained an attorney, Harry Settlor, to perform the examination of title, prepare documents, and perform the necessary tasks to record documents and transfer title. The attorney pays the recording and transfer charges and is reimbursed by the FCU.

c) City Realty drew up the sale contract and collected the earnest money.

d) Escrow accounts are required for real estate loans.

e) All disbursements are made within 10 working days of the closing date.

Entries in the FCU's Records at Settlement or closing to record disbursement of loans proceeds on the Byer-Cellar real estate transaction;

1) To record receipt of funds from John & Mary Byer on purchase of the Cellar property:

Dr. - Cash (Acct. No. 731) $8,955.66
Cr.-Net Origination Fees (Costs)-
Real Estate Loans Over 12 Years
(Acct. No. 703.1) $1,435.50
Cr.-Shares - Escrow (Acct. No. 905) 367.56
Cr.-Accounts Payable - Real Estate
Loans (Acct. No. 808) 7,152.60

2)To record the receivable for earnest money deposited by Byer with City Realty:

Dr. - Accounts Receivable - Real
Estate Loans (Acct. No. 728) $2,000
Cr.-Accounts Payable - Real Estate
Loans (Acct. No. 808) $2,000

3) To record the (Byer) real estate loan and the disbursements of funds to Cellar:

Dr. -Real Estate Loans
(Acct. No. 703) $58,000.00
Cr.-Net Origination Fees (Costs)-
Real Estate Loans Over 12 Years
(Acct. No. 703.1) $580.00
Cr.-Cash (Acct. No. 731) 7,641.46
Cr.-Accounts Payable - Real
Estate Loans (Acct. No. 808) 49,778.54

4) To record payment of real estate commissions:

Dr. - Accounts Payable - Real
Estate Loans (Acct. No. 808) $3,960
Cr.-Accounts Receivable (Acct. No. 728) $1,980
Cr.-Cash (Acct. No. 731) 1,980

5) To record the payment of fees associated with the purchase:

Dr. - Accounts Payable - Real
Estate Loans (Acct. No. 808) $54,971.14
Cr.-Cash (Acct. No. 731)
(James Appraiser) $265.00
(PMI) 290.00
(Harry Settlor) 631.67
(Title Company) 141.00
(Charles Surveyor) 100.00
(Pest Control) 20.00
(City Mutual) 53,532.47

6020.4 RECOMPUTATION FOR REBATE

The following items from Figure 6-1 "Settlement Statement" are considered finance charges and are subject to refund in accordance with 701.21 of the NCUA Rules and Regulations in the event of early repayment:

Borrower's Points	$580.00
Loan Origination Fee	580.00
Prepaid Interest	275.50
Mortgage Insurance	290.00
Total	$1,725.50

To demonstrate the acceptable method which may be used to compute the required refund, we will assume that the $58,000 loan shown on the foregoing Settlement Statement was granted at the interest rate of 9 1/4% per annum for 30 years. Further we will assume that the loan has been paid off 12 months after date of issue. For purposes of this example it is assumed that the maximum permissible interest rate at the time the loan was granted was 12% APR.

The first step in the computation is to determine the present value (PV) of the 12 monthly payments, $6,714.78 ($596.60 monthly payment x 11.2550774735 PV factor). Secondly, compute the present value of the payoff balance, $51,285.21 ($57,789.46 payoff balance x .8874492253 PV factor). The sum of the above two present values should equal the original amount of the loan since the loan in question was written with an interest rate of 1% per month.

PV of the monthly payments	=	$ 6,714.78
PV of the payoff balance	=	51,285.21
TOTAL		$57,999.99

The $.01 difference between the computed present value and the original amount of the loan ($58,000.00) is due to rounding.

A comparison of the present value of the contracted income stream using a 1% per month interest factor with the present value of the income stream if the loan had been written at 12% APR (1%) per month) will disclose the amount of prepaid charges which must be refunded due to early repayment of the loan. Since the present value of this latter income stream (12% APR loan) is always equal to the face amount of the loan, it is sufficient to compare the computed PV of the contracted income stream (using 1% interest factors) with the face amount of the note.

The amount of prepaid charges which are subject to refund is that amount required to make the computed PV equal to the face amount of the note. If the computed PV is greater than the face amount of the note, no refund is required.

The present value of the 12 monthly payments if $5,370.47, ($477.16 monthly payment x 11.2550774735 PV factor). The PV of the payoff balance is $51,137.82 ($57,623.38 x .8874492253). The sum of the above two present values will equal the present values of the total income stream to yield 1% per month.

FIGURE 6-1

A. **Settlement Statement**

U. S. Department of Housing
and Urban Development

OMB No. 2502-0265

B. Type of Loan

1. ☐ FHA 2. ☐ FmHA 3. ☐ Conv. Unins. 4. ☐ VA 5. ☐ Conv. Ins.	6. File Number	7. Loan Number	8. Mortgage Insurance Case Number

C. Note: This form is furnished to give you a statement of actual settlement costs. Amounts paid to and by the settlement agent are shown. Items marked "9p.o.c.)" were paid outside the closing; they are shown here for Informational purposes and are not Included in the totals.

D. Name and Address of Borrower	E. Name and Address of Seller	F. Name and Address of Lender
John & Mary Byer	Robert & Jane Cellar	Our FCU

G. Property Location	H. Settlement Agent	
4420 Elm Street Anywhere, USA	Harry Settlor Place of Settlement	I. Settlement Date 8/12/x1

J. Summary of Borrower'sTransaction		K. Summery of Seller's Transaction	
100. Gross Amount Due From Borrower		400. Gross Amount Due To Seller	
101. Contract sales price	66,000.00	401. Contract sales price	66,000.00
102. Personal property		402. Personal property	
103. Settlement chargee to borrower (line 1400)	3,069.06	403.	
104.		404.	
105.		405.	
Adjustments for Items paid by seller in advance		Adjustments for Items paid by seller in advance	
106. City/town taxes to		406. City/town taxes to	
107. County taxes to		407. County taxes to	
108. Assessments to		408. Assesments to	
109.		409.	
110.		410.	
111.		411.	
112		412.	
120. Gross Amount Due From Borrower	69,069.06	420. Gross Amount Due To Seller	66,000.00
200. Amount Paid By Or in Behalf or Borrower		500. Reductions in Amount Due To Seller	
201. Deposit or earnest money		501. Excess deposit (see Instructions)	4,721.67
202. Principal amount of new loan(s)		502. Settlement charges to seller (line 1400)	
203. Existing loan(s) taken subject to		503. Existing loan(s) taken subject to	
204.		504. Payoff of first mortgage loan 8/26	53,523.47
205.		505. Payoff of second mortgage loan	
206.		506.	
207.		507.	
208.		508.	
209.		509.	
Adjustments for Items unpaid by seller		Adjustments for Items unpaid by seller	
210. City/Town taxes to		510. City/town taxes to	
211. County taxes 7/1 to 8/12	113.40	511. County taxes 7/1 to 8/12	113.45
212. Assessments to		512. Assessments to	
213.		513.	
214.		514.	
215.		515.	
216.		516.	
217.		517.	
218.		518.	
219.		519.	
220. Total Paid By/For Borrower	60,113.40	520. Total Reduction Amount Due Seller	58,358.54
300. Cash At Settlement From/To Borrower		600. Cash At Settlement To/From Seller	
301. Gross Amount due from borrower (line 120)	69,069.06	601. Gross amount due to seller (line 420)	66,000.00
302. Less amounts paid by/for borrower (line 220)	(60,113.40)	602. Less reductions in amt. due seller (line 520)	(58,358.54)
303. Cash ☐ From ☐ To Borrower	8,955.66	603. Cash ☐ To ☐ From Seller	7,641.46

Previous Edition is Obsolete

HUD - 1 (3-86)
RESPA, HB 4305.2

FIGURE 6-1 (Continued)

L. Settlement Charges		Paid From Borrowers Funds at Settlement	Paid From Seller's Funds at Settlement
700. Total Sales/ Broker's Commission based on price $ 66,000 @ 6 % = 3,960			
Division of Comminnion (line 700 as follows:			
701. $ 1,980.00 to City Realty			
702. $ 1,980.00 to Suburban Realty			
			3,960.00
704.			
800. Items Payable In Connection With Loan			
801. Loan Origination Fee %		580.00	
802. Loan Discount 1 % Our FCU			580.00
803. Appraisal Fee to James Appraiser	265.00		
804. Credit Report to			
805. Lender's Inspection Fee			
806. Mortgage Insurance Application Fee to			
807. Assumption Fee			
808. Borrower's points		580.00	
809.			
810.			
811.			
900. Items Required By Lender To Be Paid in Advance			
901. Interest from 8/12 to 8/13 @$ 14.50 iday (19)		275.00	
902. Mortgage Insurance Premium for 12 months to PMI		290.00	
903. Hazard Insurance Premium for years to			
904. years to			
905.			
1000. Reserves Deposited With Lender			
1001. Hazard Insurance 2 months@$ 11.00 per month	22.00		
1002. Mortgage insurance 2 months@$ 12.08 per month	24.16		
1003. City property taxes months@$ per month			
1004. County property taxes 4 months@$ 80.35 per month	321.40		
1005. Annual assessments months@$ per month			
1006. months@$ per month			
1007. months@$ per month			
1008. months@$ per month			
1100. Title Charges			
1101. Settlement or closing fee to Harry Settlor			30.00
1102. Abstract or title search to			
1103. Title examination to Harry Settlor		200.00	
1104. Title Insurance binder to			
1105. Document preperation to Harry Settlor			25.00
1106. Notary fees to			
1107. Attorney's fees to Harry Settlor			30.00
(includes above Items numbers:)			
1108. Title insurance to Title Company		141.00	
(includes above Items numbers:)			
1109. Lender's coverage $ 141.00 - 58,000.00			
1110. Owner's coverage $ 233.00 - 66,000.00			
1111. 92.00 - 8,000.00 OPT.			
1112.			
1113.			
1200. Government Recording and Transfer Charges			
1201. Recording fees: Deed $ 11.00 : Mortgage $ 11.00 : Releases $ 10.67	22.00	10.67	
1202. City/county tax/stamps: Deed $ 33.00 : Mortgage $ 29.00		62.00	
1203. State tax/stamps: Deed $ 99.00 : Mortgage $ 87.00	186.00		
1204. State Transfer Tax			66.00
1205.			
1300. Additional Settlement Charges			
1301. Survey to Charles Surveyor		100.00	
1302. Pest inspection to Pest Control			20.00
1303.			
1304.			
1305.			
1400. Total Settlement Charges (enter on lines 103, Section J and 502, Section K)	3,069.06	4,721.67	

PV of the monthly payments	=	$ 5,370.47
PV of the payoff balance	=	51,137.82
PV of income stream to yield 1%	=	$56,508.29

The amount of prepaid charges not subject to refund in this example is as follows:

Face Amount of Note	=	$58,000.00
PV of Income Stream	=	56,508.29
Amortized Prepaid Finance Charges	=	$ 1,491.71

The difference between the prepaid finance charges ($1,725.50) and the amortized prepaid finance charges ($1,491.71) are subject to refund. The amount subject to refund in the example is $233.79.

Another method which can be used to compute the refund is to project all payments into the future (to the date of payoff) using future values. Using this method, a short hand computation of the amount of refund is as follows:

1.	PV of Monthly Payments	$ 5,370.47
2.	Plus PV of Payoff Amounts	51,137.83
3.	Plus Prepaid Service Charges	1,725.50
4.	Equals Equivalent PV	58,233.80
5.	Less: Face Amount of Note	58,000.00
6.	Equals" Amount Subject to Refund	$ 233.80
7.	Times FV Factor	1.126825
8.	Equals Amount of Refund	$ 263.45

If item 5 is greater than item 4 no refund is required.

If a credit union distributes excess earnings to borrowers through an interest refund, the effect of such refund must be included in the above recomputation. The present value of an interest refund paid would act to reduce the amount of refund in the above examples. However, this is the amount subject to refund if it had been paid at the time the loan was granted. Since it is being repaid at a time one year later, a larger amount is due the borrower. This larger amount is the equivalent of $233.80 with interest at 12% APR compounded monthly, or $263.45. This value can be determined by using the future value computed as follows: $233.80, amount subject to refund, x 1.1268250301, FV factor, = $263.45.

6020.5 FLOOD INSURANCE

When a credit union is going to make, increase, extend or renew a loan secured by improved real estate or a mobile home, three things must be determined.

a) It must be determined if the improved real property or mobile home securing the loan is or will be located in an area that has special flood hazards, as determined by the Director of the Federal Emergency Management Agency (FEMA).

b) It must be determined if the property is or will be located in a community participating in the National Flood Insurance Program or if it is or will be located in a nonparticipating community.

c) If the property is or will be located in a community participating in the National Flood Insurance Program, it must be determined if the community is participating in the Emergency Program or in the Regular Program.

The credit union must then determine if the property is or will be located both in a special flood hazard area and in a community participating in the National Flood Insurance Rate Map or the current Flood Hazard Boundary Map for the area.

The borrower must buy flood insurance if the improved real property or the mobile home is or will be located both in a special flood hazard area and in a community participating in the National Flood Insurance Program. The borrower may buy flood insurance from any insurance agent or broker licensed to do business in the state where the property is located.

The amount of the insurance must be at least equal to the outstanding balance of the loan or to the maximum amount available under the Flood Disaster Protection Act, whichever is less. The m ‘ m amount of the flood insurance available will vary depending on whether the community is Participating in the Emergency or Regular Program.

The insurance must cover the building or the mobile home and any personal property securing the loan (It need not cover the land). It must remain in effect until the loan is repaid. If the borrower does not buy flood insurance that meets these requirements, a federally insured credit union cannot make, in , extend or renew a loan by the improved real property or mobile home.

Once it has been determined that the improved real property or mobile home is or win be located in a special flood hazard area and before the mortgage or any other notary agreement is signed, a federally insured credit union must give the borrower a written notice of that fact. This notice need not be given if the seller or lessor of the property states in writing that he or she has already given the notice to the borrower and the borrower acknowledges this. In addition, a federally insured credit union must give the borrower a written notice that says whether federal disaster relief assistance will be available if the property is damaged by flooding in a federally declared disaster.

Federal disaster assistance will be available if the property is located in a community participating in the National Flood Insurance Program. Before the loan note is signed, the credit union must also have the borrower acknowledge in writing that he or she received these notices. This acknowledgment has to be kept on file until the loan is repaid.

The credit union must keep records that show how it determined if flood insurance would be required and how it determined whether to give the Federal Disaster Assistance Notice. If a Flood Interest Rate Map or Flood Hazard Boundary Map was used, the address of the property and the number of the Map are all that are necessary.

6020.6 REGULATION C - HOME MORTGAGE DISCLOSURE ACT

The Home Mortgage Disclosure Act is a law which requires depository institutions, including credit unions, to disclose publicly where its mortgage loans have been granted, The purpose of the law is to provide for the development and disclosure of sufficient information for interested persons and public officials to determine whether depository institutions were fulfilling their lending obligations to serve the housing need of all segments of neighborhoods in which they are located. The term most frequently associated with discrimination in mortgage lending is “redefining.” This occurs when depository institutions rule out certain residential areas of a city for mortgage credit or discriminates against various groups of residents.

A credit union which meets all three of the following conditions is subject to the Act:

a) It must have over $10 million in assets at the end of its most recent fiscal year.

b) It must maintain an office (main or branch) in one or more SMSA (Standard Metropolitan Statistical Area) as established by the Office of Management and Budget.

c) It must make federally related residential mortgage loans. A federally related mortgage loan is any loan secured by a first lien on residential real property, made by a depository institution regulated or insured by an agency of the Federal Government, or made with the intent of being sold to FNMA or GNMA, etc.

If a credit union meets this criteria, it should refer to the revised Manual of Laws Affecting Federal Credit Unions for instructions on complying with this Act.

6030 PURCHASE, SALE, AND PLEDGE OF ELIGIBLE OBLIGATIONS

Under provisions of Sections 701.22 and 701.23 of the National Credit Union Administration (NCUA) Rules and Regulations, federal credit unions are authorized to:

a) Purchase, sell, or pledge to any source eligible obligations of its members;

b) Purchase eligible obligations of a liquidating credit union’s members;

c) Purchase student loans from any source, if they grant this type of loan on an on-going basis, and if the purchase will aid in the packaging of a pool of these loans so that they may be pledged or sold on a secondary market; and

d) Purchase real estate loans from any source, provided they grant real estate loans on an on-going basis in accordance with Section 701.21 of the NCUA Rules and Regulations and the sale will aid in the purchaser's packaging of a pool of these loans so that they may be pledged or sold on the secondary mortgage.

The purpose of this portion of the law is to provide federal credit unions with greater flexibility in satisfying members' requests for loans and share withdrawals while spreading the risk of these needs. Federal credit unions granting these student loans and long-term real estate loans will have an easier access to the respective secondary markets. This will improve the credit union's ability to react quickly and efficiently to satisfy liquidity needs.

6030.1 DEFINITIONS RELATING TO PURCHASE, SALE OR PLEDGE OF ELIGIBLE OBLIGATIONS

Sections 701.22 and 701.23 establish certain definitions and requirements for federal credit unions which elect to participate in the purchase, sale, or pledge of eligible obligations. The requirements established in those regulations are not repeated here. Rather, you are referred to those sections to determine those requirements as applicable to your situation.

6030.1.1 DEFINITIONS CONCERNING THE PURCHASE, SALE, OR PLEDGE OF ELIGIBLE OBLIGATIONS

The definitions are included below.

Credit Union. Any federal or state-chartered credit union.

Credit Union Service Organization. An organization satisfying the requirements of Section 701.27 of NCUA's Rules and Regulations..

Eligible Obligation. A loan or group of loans.

Eligible Organizations. A credit union, a credit union service organization, or a financial institution.

Financial Institution. Any federally chartered or federally insured financial institution.

Net Loans. The gross amount of the loans, including finance and service charges and fees owed by the member, less related unearned finance changes and fees.

Originating Lender. The participant (credit union) with which the member (borrower) contracts.

Participation Loan. A loan made in participation with one or more eligible organizations.

Probable Adjustments. Adjustments for the failure of the members to pay when due (i.e., estimated loan losses and collection costs), the estimated effects of prepayments, and weaknesses in the loan underwriting (i.e., lack of clear title).

Recourse. The right of a buyer of loans to receive payment from the credit union (seller of the loans) for the failure of the member to pay when due, the effects of prepayments, or other reasons for loss.

Student Loan. A loan granted to finance the borrower's attendance at an institution of higher education or at a vocational school, which is secured by and on which payment of the outstanding principal and interest has been deferred in accordance with the insurance or guarantee of the Federal Government, State government, or any agency of either.

6030.1.2 ACCOUNTING FOR FEES GENERATED FROM THE PURCHASE, SALE, OR PLEDGE OF ELIGIBLE OBLIGATIONS

Various types of fees may be generated when loans are purchased, pledged, or sold. There are several methods used to account for these fees. The methods differ, generally, in the timing of recognition of income from syndication, origination, and participation fees.

Discussion of these types of fees and the requirements which determine which type of fee and the corresponding accounting treatment for the fees (and the recognition of the income from these fees) is beyond the scope of this Manual. Federal credit unions which engage in activities which generate such fees are to account for these fees in accordance with FASB 91. Those credit unions which must account for such fees and are unable to adequately implement FASB 91 should consult an independent accountant for assistance and guidance in the proper treatment of such fees.

6030.2 PURCHASE OF ELIGIBLE MEMBER OBLIGATIONS

A federal credit union can purchase a member's loan that it could not grant. Within 60 days from the date of purchase, however, the loan must be refinanced in accordance with the federal credit union's policies. For example, a consumer loan bearing interest at an annual rate of 16 percent could be purchased if the credit union member consents to a refinancing at an interest rate that is in accordance with the board of directors' policies and the Federal Credit Union Act.

In the situation where the loan being purchased is an obligation, or is endorsed by a credit union official of the federal credit union purchasing the loan, board of directors' approval will be required if board approval would have been needed for the officer's endorsement or granting of the loan directly from his or her credit union. Board approval is not required where an official's loan, or a loan, endorsed or guaranteed by the credit union official, is purchased from a liquidating credit union or where the loan is purchased for pooling purposes.

6030.2.1 FIVE PERCENT LIMITATION ON ELIGIBLE OBLIGATION PURCHASES

Except as stated previously, the total unpaid balances of eligible obligations purchased cannot exceed 5 percent of the unimpaired capital and surplus of the purchaser. Student and real estate loans purchased under terms of NCUA Rules and Regulations Section 701.23 shall not be included in considering this 5 percent limitation.

6030.2.2 TEN PERCENT LIMITATION

The total indebtedness owing to any federal credit union by any person (member or nonmember), inclusive of retained and re-acquired interests, shall not exceed 10 percent of the credit union's unimpaired capital and surplus.

6030.3 STUDENT LOANS

Federal credit unions may purchase nonmember student loans from any source for the purpose of including the loans in a package or pool of loans that will be sold or pledged to a secondary market. However, prior to the credit union's purchase of these nonmember student loans, arrangements should be made for a secondary market to purchase the pool of loans in which they are included.

Student loans purchased to package a pool of loans will not be included in determining whether the total of unpaid notes purchased has exceeded the 5 percent notation that is based on the credit union's paid-in and unimpaired capital and surplus.

6030.4 REAL ESTATE LOANS

Real estate loans can only be purchased if they were used to finance the purchase of one-to-four family dwelling that is or will be the principal residence of the borrower and if the loan is secured by a perfected first lien on this dwelling.

As stated previously, in order for a federal credit union to be eligible to purchase real estate loans, it must have adopted a policy of granting long-term real estate loans and must actually be granting these loans (i.e., accepting applications, processing them, and disbursing its own funds) on an on-going basis.

The purchase of real estate loans must be for the purpose of including the loans in a substantial pool of its own loans. Once it sells or pledges the pool of loans, the credit union must grant more loans before a second package or pool of loans can be assembled.

If the board of directors decides to stop granting real estate loans, the credit union will still be considered by the National Credit Union Administration as a credit union that is granting real estate loans on an on-going basis for a reasonable period such as 60 days. Prior to this time, real estate loans may be purchased for pooling purposes provided that they are disposed of promptly.

Since the credit unions will be purchasing loans and obligations of nonmembers and loans they could not grant, they will be expected to sell or pledge the pool of loans promptly. Arrangements should be made in advance of the purchase date, by obtaining a commitment from a buyer, to purchase the pool of loans before it is actually packaged.

6030.5 SALE OF ELIGIBLE MEMBER OBLIGATIONS

A credit union may sell any member obligation with the approval of the board of directors. Examples of circumstances where a credit union might sell members' loans include closing a branch (members are served better by another credit union) or terminating a particular loan type (such as no longer offering credit cards). However, the most common form of such a transaction is the sale of mortgage loans, either individually to a secondary market investor or via securitization of a pool of loans.

Loans may be sold with or without recourse. Recourse refers to the acceptance, assumption, or retention of some or all of the risk of loss generally associated with owning a loan. In addition to risk, recourse refers to control of some future economic benefit relating to the loan. Examples of recourse provisions include:

- Credit union (seller) must reimburse buyer in full, by repurchasing the loan or otherwise, regardless of the status of the collateral securing the loan.
- Credit union (seller) must reimburse buyer in the amount of loss after repossession of the collateral. Collateral may be sold by either party, depending on the recourse agreement.
- Credit union (seller) must reimburse the buyer a limited amount, such as a stipulated dollar amount or a percentage of the loans sold.
- Buyer retains a portion of the selling price in a separate reserve to ensure performance (commonly known as a dealer's reserve).

6030.5.1 SALE WITHOUT RECOURSE

The sale of loans without recourse generally removes all risk from the selling credit union. True "without recourse" sales are recorded through the income statement, with any gains or losses on the sale recognized in the period of the sale.

Illustrative Entries

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a) Credit union sells $500,000 of member loans without recourse for $475,000 cash.

Dr. - Cash (Acct. No. 730) $475,000
Dr. - Loss on Sale of Loans
(Acct. No. 140) 25,000
Cr.-Loans (Acct. No. 701) $500,000

b)Credit union sells $500,000 of member loans without recourse for $525,000 cash.

Dr. - Cash (Acct. No. 730) $525,000
Cr.-Loans (Acct. No. 701) $500,000
Cr.-Gain on Sale of Loans
(Acct. No. 140) 25,000

Additional discussions and illustrative entries for these types of sales are provided in part 6030.8.2

6030.5.2 SALE WITH RECOURSE

Loans are more commonly sold with some type of recourse. That is, the selling credit union retains some risk associated with the loans. There are numerous types of recourse arrangements a credit union may offer including the following:

- The credit union may agree to absorb losses up to a certain percentage of the loan balance;
- The credit union may create a subordinate security to stand first in line to recognize any loss;
- The credit union may originate both a first and second mortgage on the same property, sell the first and retain the second mortgage in order to provide some protection for the first; or
- The credit union may agree to replace a nonperforming asset that it has sold into a pool with a performing one that it has retained on its books.

The sale of loans with recourse should be recorded as a regular sales transaction through the income statement only if all three of the following conditions exist:

1) The selling credit union must surrender control of the future economic benefits embodied in the asset;
2) The selling credit union must be able to reasonably estimate its obligations under the recourse provisions; and
3) The selling credit union must not be obligated to repurchase the assets except pursuant to the recourse provisions.

6030.5.2.1 RECOURSE SALE RECORDED AS A SALE

Assuming that all three of the required conditions are met, the credit union should accrue all probable adjustments necessary for loss contingencies. See Sections 2050.1.10 and 4050.5 Liability Accounts (856-Accrued Loss Contingencies) for more information. Additionally, the difference between the sales price (adjusted for the accrual of probable adjustments) and the net loans should be recognized as a gain or loss on the sale.

Illustrative Entries

a) Credit union sells $500,000 of member loans with recourse for $475,000 cash. The recourse calls for the credit union to pay not more than 20 percent of the total principal of the sale in the event of default (maximum contingency is 20 percent of $500,000 or $100,000). All requirements of sale are met.

Dr. - Cash (Acct. No. 730) $475,000
Dr. - Loss on Sale of Loans
(Acct. No. 140) 125,000
Cr.-Loans (Acct. No. 701) $500,000
Cr.-Accrued Loss Contingencies
(Acct. No. 856) 100,000

b) Credit union sells $500,000 of member loans with recourse for $625,000 cash. The recourse calls for the credit union to pay not more than 20 percent of the total principal of the sale in the event of default (maximum contingency is 20 percent of $500,000 ore $100,000). All requirements of sale are met.

Dr. - Cash (Acct. No. 730) $625,000
Cr.-Loans (Acct. No. 701) $500,000
Cr.-Accrued Loss Contingencies
(Acct. No. 856) 100,000
Cr.-Gain on Sale of Loans
(Acct. No. 140) 25,000

6030.5.2.2 RECOURSE SALE RECORDED AS A LIABILITY

If all three of the required conditions are not present, the transaction must be recorded as a pledge of security on a loan (a liability) rather than as a sale. Both the loans and the related liability are removed from the credit union's books as the obligation under the recourse agreement is reduced as a result of loan payoffs, loan paydowns, or full repurchase by the credit union under the recourse agreement.

Illustrative Entries

a) Credit union sells $500,000 of member loans with recourse for $475,000 cash. The recourse agreement calls for the credit union to repurchase any or all of the loans if and when they become more than 90 days delinquent. At the time of repurchase, the credit union must reimburse the buyer an amount equal to the remaining principal of the defaulted loan, plus accrued interest income and all collections costs.

Because the credit union's obligations under this recourse agreement cannot be reasonably estimated, the sale must be recorded as a liability, as follows:

Dr. - Cash (Acct. No. 730) $475,000
Cr.-Other Liabilities
(Acct. No. 860) $475,000

b) Suppose the buyer exercised the right of recourse for loans with total outstanding principal of $30,000. The buyer also recorded accrued interest income of $2,500 and collections costs of $300. Under the terms of the recourse agreement, the credit union must repurchase the loans and pay costs, for a total amount owed of $32,800.

Dr. - Other Liabilities
(Acct. No. 860).. $30,000
Dr. - Loan Interest Income
(Acct. No. 110).. 2,500
Dr. - Collection Expenses
(Acct. No. 282).. 300
Cr.-Cash (Acct. No. 730) $32,800

Note that no entry is required to Acct. No. 701-Loans because the original entry did not remove them from the credit union's books. By repurchasing the loans, the credit union's liability under the recourse agreement has been reduced. Additionally, the credit union recognizes the extra costs under the recourse agreement as a reduction in loan interest income and increased expense. No gain or loss is recognized because the sale was never completed.

c) During a given month principal paydowns/payoffs equal $50,000. The credit union's liability under the recourse agreement is reduced in proportion to the amount of loans paid off, and gains/losses are recognized as the liability is reduced.

Dr. - Other Liabilities
(Acct. No. 860) $47,500
Dr. - Loss on Sale of Loans
(Acct. No. 140) 2,500
Cr.-Loans (Acct. No. 701) $50,000

The amount of liability reduction is $47,500 [total original liability of $475,000 times 10 percent [$50,000 principal paydown divided by $500,000 total loan principal]]. The difference between the amount of principal paydown and the amount of liability reduction is the amount of gain/loss to be recognized ($50,000 less $47,500 is $2,500).

6030.5.2.3 DISCLOSURE REQUIREMENTS

The selling credit union's financial statements must disclose the following items, even if the possibility of loss from recourse is considered only remote:

1) The amount of proceeds from the sale;

2) The principal amount of the sale;

3) The nature and terms of the sale including the credit and market risk and the cash requirements of the loans sold;

4) The amount of accounting loss the credit union would incur if any party failed to perform or if related collateral had no value;

5) All relevant information regarding the collateral involved; and

6) Concentrations of credit risk to any member or group of members.

These disclosures are required in addition to any others that might be required under generally accepted accounting principles, such as those required for extraordinary items and related party transactions.

6030.6 PLEDGE OF ELIGIBLE MEMBER OBLIGATIONS AS SECURITY

A credit union may also pledge member loans as collateral for a loan. Such a transaction is recorded on the general ledger as a note payable. No gains or losses are recognized, and there is no effect on the members' loan accounts in the general ledger.

Federal credit unions pledging member loans as security for a loan to the credit union must retain copies of the original loan documents on file. The documents must be made available for review by NCUA examiners so that compliance with applicable laws and sound credit union practices can be determined.

6030.7 ACCOUNTING FOR THE PURCHASE, SALE, AND PLEDGE OF ELIGIBLE OBLIGATIONS

6030.7.1 LOANS PURCHASED

When loans are purchased, the seller assigns the notes to the purchasing credit union. The notes or mortgages, and other supporting documents for each loan are assigned and transmitted to the purchasing federal credit union.

The accounting for the purchase will include determining the face amount of the loan, the amount of the discount received or the premium paid, and the amount of accrued interest due to the date of the transaction. Illustrated below are three typical accounting entries to record loans purchased.

Example (1). Assume the ZDK FCU purchased at par $100,000 of loans that had no unpaid or accrued interest. No fees were paid; no fees were received. The entry to record the purchase would be:

Dr. - Loans and Other Obligations Purchased (Acct. No. 714)	$100,000	
Cr.-Cash (Acct. No. 731)		$100,000

Example (2). Assume that the same credit union purchased a group of loans that had a book value of $100,000. The credit union had to purchase the loans for $110,000 because this was the existing market value of the loans at the time. The difference between the book value of the loans and the price that was paid is called the premium. No additional fees were paid or received. The loans had $1,050 of unpaid (accrued interest) that was also purchased:

Dr. - Loans and Other
  Obligations Purchased
  (Acct. No. 714)..$100,000
Dr. - Purchased Accrued Interest
  Receivable on Loans
  (Acct. No. 755).. 1,050
Dr. - Premiums on Loans
  Purchased (Acct. No. 714.1) 10,000
  Cr.-Cash (Acct. No. 731) $111,050

Example (3). Assume another situation where the ZDK FCU purchased a group of loans that had a book value of $100,000. Because market conditions were less favorable, the credit union only had to pay $95,000 for the loans plus the accrued or unpaid interest to the date of sale of $900. No fees were paid; no fees were received. The difference between the book value and the amount paid for the loans is the discount. The entry to record the transaction would be:

Dr. - Loans and Other
  Obligations Purchased
  (Acct. No. 714)..$100,000
Dr. - Purchased Accrued Interest
  Receivable on Loans
  (Acct. No. 755).. 900
  Cr.-Cash (Acct. No. 731) $95,900
  Cr.-Discount on Loans Purchased
    (Acct. No. 714.2).. $5,000

Generally, the selling institution or person retains a percentage ownership in the loans (i.e., 10 percent) that are sold so that the original borrower continues to pay his or her loans to the institutions from which he or she borrowed the funds. The servicer charges the purchasing credit union a fee for this service, the terms of which are included in the sales agreement.

Illustration:

Assume the same facts as in Example #3 and that the credit union received from the servicer the first monthly payment of $3,321 including interest on the group of loans. Average maturity for this group of loans was 36 months. The entry to record the payment with a $30 servicing fee and interest rate of 1 percent per month on the unpaid loan balance would be:

Dr. - Cash (Acct. No. 731)	$3,291	
Dr. - Service Fees on Loans Purchased (Acct. No. 287)	30	
Cr.-Purchased Accrued Interest Receivable (Acct. No. 755)		$900*
Cr.-Interest on Loans and Other Obligations Purchased (Acct. No. 115)		100*
Cr.-Loans and Other Obligations (Acct. No. 714)		2,321

*Interest on loans consists of $900 of purchased accrued interest and $100 of additional income earned from the date of purchase.

In addition to this entry, the purchasing credit union would amortize the discount on loans purchased based on the interest method. This method is discussed in detail in Section 4050.4, Account No. 703.1.

Dr. - Discount on Loans Purchased (Acct. No. 714.2)	$138.89	
Cr.-Interest on Loans and Other Obligations Purchased (Acct. No. 115)		$138.89

Assuming a premium was paid, the following entry would be made:

Dr. - Interest on Loans and Other Obligations Purchased (Acct. No. 115)	$277.78	
Cr.-Premiums on Loans Purchased (Acct. No. 741.1)		$277.78

6030.7.1.1 SUBSIDIARY RECORDS

A separate subsidiary record should be established for each individual loan purchased. Loans and Other Obligations Purchased (Account No. 714) will serve as a control account for the balance of the purchased loans outstanding. Each subsidiary ledger could be titled, “Loans and Other Obligations Purchased” - serviced by ____ federal credit union, or ____ Association, etc., accompanied by a subaccount number (i.e., 714.001, 714.002).

The detail of the loan transaction payment is processed in accordance with regular posting procedures, using the details of a remittance report as discussed in the next paragraph. Posting of payments to the detailed subsidiary records includes, as a matter of proof, comparing the balances of each subsidiary ledger with their respective remittance report.

Remittance of payments is made at agreed times by the servicer(s) of the loan accounts. The form of the remittance report to be agreed upon should contain all the information required for the processing needs of both the purchaser and the seller. Figure 6-2 is an example of a "Detailed Report of Loans Serviced."

6030.7.1.2 ESCROW ACCOUNTS

Processing of escrow accounts for taxes, insurance, and other charges to be paid by the borrower will normally remain the responsibility of the servicer, who handles these details on behalf of the purchaser. Thus, no accounting is required of the purchasing credit union unless a borrower's escrow account becomes overdrawn and reimbursement to the servicer is requested. If this situation occurs, the following entry will be made, assuming the amount is $750:

Dr. - Advances for Taxes,
Insurance, and Other
Charges (Acct. No. 725) $750
Cr.-Cash (Acct. No. 731) $750

A detailed accounting of the charges must be maintained. Recovery of the charges will result in the reversal of the above illustrative entry.

6030.7.2 LOANS SOLD (SERVICING RETAINED)

Assuming that the selling credit union will continue to service the loans, with only a few exceptions, the administration, accounting, and control of the loans sold, will be the reverse of loans purchased. There are two exceptions to this rule: one exception relates to the treatment of escrow funds collected from the borrower; and the other exception concerns the relationship of loans sold to the other loans in the loan ledger accounts and the disposition of the collections on these accounts.

With regard to escrow funds collected from the borrower for payment of property taxes, mortgage and hazard insurance, and similar expenses that are the responsibility of the borrower, a different situation exists as compared to when loans are purchased. When a sale is consummated, the funds collected by the servicer, and those that were previously accumulated, remain the possession of the servicer, or the seller in this instance, and are disbursed by the servicer.

FIGURE 6-2: Illustration of a Completed Report of Loans Sold and Being Serviced

Detailed Report of Loans Serviced.

LOANS SERVICED BY ABC FEDERAL CREDIT UNION
AND SOLD TO
ZDK FEDERAL CREDIT UNION

(1) Acct. No.	(2) Name	(3) % Int. Rate	(4) Monthly Payment	(5) Balance Last Report	(6) Interest	(7) Payment	(8) Misc. Charges	(9) Balance This Report
8495	E. J. Majors	12	$128.00	$8,800.00	$88.00	$128.00		$8,760.00
8499	W. P. Barth	12	176.00	12,848.92	128.50	176.00		12,801.42
8507	Z. K. Jones	12	236.00	15,368.83	153.68	236.00	$20.75	15,307.26
8512	P.W. Farth	12	190.00	10,915.86	109.16	190.00	35.00	10,870.02
				$479,336.10	$2,396.70	$3,650.00	$557.50	$478,640.30

Column 1: Account number of the reporting credit union or, if it is found desirable, the account number assigned by the purchasing credit union or a number common to both the purchaser and the seller.
Column 2: Name of the borrower.
Column 3: Interest rate, usually shown in account number order; on larger reports, shown in account number order by rate.
Column 4: Amount of the contractual payment.
Column 5: Last trial balance on the previous month's report, in order to give continuity to the last report submitted.
Column 6: Amount of interest posted to the loan and charged to the balance.
Column 7: Amount of the actual payment or payments. Any miscellaneous credits are also recorded in this column.
Column 8. Charges from any source other than interest.
Column 9. Current trial balance of the loans at the end of the day on the date of the report.

Columns 5, 6, 7, 8 and 9 are totaled and should cross-foot by adding column 7 and subtracting columns 5,6 and 8 which should equal the column 9 total.

In regard to the relationship of loans to the other loans in the loan ledger accounts and the collections of the payments on those accounts, the situation is different in a sale as compared to a purchase. After a sale, there are no further General Ledger Accounts for the principal balances of the loans, unless a percentage of ownership is retained. Also in this situation, the accounting to the borrower remains the responsibility of the selling credit union and posting to his account record continues under the same procedures as before the sale.

The transactions at a teller's window for loans sold will be intermingled with members' regular loan transactions. Whatever the circumstances, all payments collected for the loans (loan account ledgers) sold must be segregated when balancing and summarizing cash receipts. The collections will be credited to "Collections on Loans and Obligations Serviced (Account No. 862). In addition, the servicer will be responsible for preparing the remittance report to the purchaser according to the terms of the service contract.

6030.7.2.1 LOANS SOLD AT A PREMIUM

If a loan is sold at a premium, the excess will result in a profit to the selling credit union. This will require crediting the income accounts within the accounting period in which the sale was consummated. The following entry illustrates this type of sale:

Assume that SMART Federal Credit Union sold $100,000 of Ralph Baker's (credit unions member borrower) new yacht loan of $110,000. The loan was a 12% loan computed according the US Rule and had a maturity of 60 months. The $100,000 portion of the loan was sold to Brooks Federal Credit Union for $102,000. Assume further that there is half month's interest due at the time of the sale. The entry to record this sale would be:

	Dr.	Cr.
Dr. - Cash (Acct. No. 731)	$102,500	
Cr.-Loans (Acct. No. 701)		$100,000
Cr.-Interest on Loans (Acct. No. 111)		500
Cr.-Gains or (Loss) on Sale of Loans and Other Eligible Obligations (Acct. No. 140)		2,000

If the above loan would have been a loan purchased from another credit union (subsequently sold to Brooks Federal Credit Union), any credits that were the result of the original purchase would also have to be charged (debited) or credited to "Gain or (Loss) on Sale of Loans and Other Eligible Obligations Purchased" (Account No. 140), thereby adjusting the profit on the sale.

6030.7.2.2 LOANS SOLD AT A DISCOUNT

If loans are sold at a discount (sale price is less than the book's loan balances), and there are unamortized discounts or acquisition fees applicable to the sold loans, the entry to record the sale would be as follows:

FIGURE 6-3: Illustration of a Completed Summary Report of Loans Sold and Being Serviced

Summary Report of Loans Serviced
Sale By
SMART Federal Credit Union
TO
Brooks Federal Credit Union
DATE: As of________________ :

Total Payments	$ 3,650.50
Less Miscellaneous Charges	557.00
Net Collections Loans Serviced	$ 3,093.50
Less Service Fee	125.00
Proceeds to Purchaser	$ 2,968.50

FIGURE 6-4: Illustration of a Completed Summary Report of Loans Sold and Being Serviced

Summary Report of Loans Participations
ABC Federal Credit Union
Sale of Participation Loans to
XYZ Federal Credit Union
As of December 31, 19X1

Total Payment		$ 3,650.00	
Less Interest		2,396.70	
Less Miscellaneous Charges		557.50	
Principal Reduction		$ 695.80	
50% to Purchaser			$ 347.90
Interest Charged	$2,396.70		
50 % to Purchaser		1,198.35	
Less Service Charge per Agreement		99.87	
Net interest			1,098.48
Total Remittance			$ 1,446.38

Assume the same example as in Section 6030.7.2.1, except that the $100,000 portion of the $110,000 yacht loan was sold for $95,000 and that the loan has $3,000 of unamortized discount purchased applicable to the $100,000 portion:

Dr. - Cash (Acct. No. 731)	$95,500	
Dr. - Discount on Loans Purchased (Acct. No. 714.2)	3,000	
Dr. - Gain or (Loss) on Sale of Loans and Other Eligible Obligations (Acct. No. 140)	2,000	
Cr.-Loans (Acct. No. 701)		$100,000
Cr.-Interest on Loans (Acct. No. 111)		500

If, in either of these examples, there is interest that is collected but unearned at the time of the sale, the sale entry must include a debit to "Interest on Loans," (Account No. 111). There may be both accrued and precollected interest in a group of loans that are sold. When this occurs the interest column on the sale schedule needs to be footed to a net figure so that it will appear as either a debit or credit to "Interest on Loans," (Account No. 111).

Escrow balances on the loans sold are transferred from "Advances for Taxes and Insurance," (Account No. 725) to "Advance Payments by Borrowers for Taxes and Insurance on Serviced Loans," (Account No. 797). Escrow payments collected and disbursements for charges to these accounts are processed the same as before the sale.

Posting procedures for the individual loan accounts are also the same as before the sale. At the time of the sale, a memorandum control account should be set up to reflect and control the total balances of these accounts. This control is not part of the General Ledger Accounts. The individual loan subsidiaries are segregated in the file for the purposes of reporting collections to the purchaser of the accounts.

When the required report is prepared for the purchaser, the total collections must agree with "Collections on Loans and Other Obligations Serviced," (Account No. 862) where the loan payments were recorded as being received. The ending balances on the report must agree with the balance in the memorandum control account.

Another exception to the fact that a sale is treated like a purchase, is that the servicer is responsible for preparing the remittance report that is sent to the purchaser. The form and details of reporting are determined from the service contract. Reporting facilities of the servicer as well as the needs of the purchaser will determine the specific form of the report. Figure 6-2 illustrated this report earlier in this section. Figure 6-3 is an example of a Summary Report of Loans Serviced. An example entry showing payments to the purchasing credit union is also provided.

Illustrative Entry:

Dr. - Collection on Loans and Other Obligations Serviced (Acct. No. 862)	$3,093.50	
Cr.-Service Income on Loans and Other Obligations (Acct. No. 160)		$125.00
Cr.-Cash (Acct. No. 731)		2,968.50

6030.8 PARTICIPATION LOANS

The primary difference between purchasing and selling participation loans is that in the participations, title to the loans does not normally transfer to the purchaser. The seller retains title to the accounts and sells only a part interest in the loans to the purchaser. The seller continues to account for the loan payments and the borrower is not informed of any change in ownership of his loan.

The purchasing credit union's records consist only of the original listing of loans, the sale agreement, and the subsequent remittance reports from the seller. Detailed ledger records are not established.

The original listing of loans, the sales agreement, and the remittance reports should contain any needed information as to balances or loan payment status on individual loans. The original listing should also include a record of any accrued interest and/or interest that is precollected.

A separate control account is established for each participation package and the total balances of each control account must agree with "Loan Participations Purchased," (Account No. 715). The control account is the same as an Individual Loan Ledger and is posted in the same manner as when a remittance is received from a seller for a regular loan purchased by the credit union. A normal entry evidencing a loan participation purchase would be:

Dr. - Loan Participations Purchased (Acct. No. 715)	$10,000	
Dr. - Accrued Interest on Loan Participations Purchased (Acct. No. 786)	200	
Cr.-Cash (Acct. No. 731)		$10,200

A detailed report for such a purchase is the same as shown for Figure 6-2. Settlement remittance for receipts on participation loans by the seller will be made in accordance with the participation agreement. The separation of interest from principal is illustrated in Figure 6-4.

The Journal and Cash Record entry for the above remittance that is collected by the seller would be:

Dr. -Cash (Acct. No. 731)	$1,446.38	
Dr. - Service Fees on Loans Purchased (Acct. No. 287)	99.87	
Cr.-Loans Participation Purchased (Acct. No. 715)		$347.90
Cr.-Interest on Loans Participations Purchased (Acct. No. 116)		1,198.35

6030.9 LOAN PARTICIPATIONS SOLD

Credit unions may experience a situation where their loan demand will exceed the inflow of share deposit and certificate purchases, and as a result a liquidity management problem arises.

A means of resolving part or all of the problem is to generate additional funds for loans by selling a partial interest on loans to other credit unions or other financial institutions or individuals. These participation loans are generally sold at par (amount equal to unpaid for a specified rate of return (yield rate) to the purchaser.

A servicing agreement may be part of the sale agreement and the selling federal credit union might charge a servicing fee (i.e., 1/2 of 1 % or 1/4 of 1 % of the unpaid balances) to reimburse the credit union for the costs involved in servicing the loans.

There is no change in accounting for the sale of the loans, except that the loan accounts must be identified and shifted to a separate section of the Individual Loan Ledger (manual or computer) files. A transfer is then made from "Loans to Members," (Account Nos. 701-709) to "Loan Participations Sold," (Account No 716).

Reporting procedures are accomplished by copying the transaction from the respective Individual Loan Ledger to the remittance reports for the timeframes established in the participating agreement. Transactions with the participating purchaser are reflected in the Liability Account No. 716.1, "Loan Participations Sold" (contra account). A transfer of the accounts is then recorded in the Journal and Cash Record as follows:

Dr. - Loan Participations Sold
(Acct. No. 716) $100,000
Cr.-Loans to Members
(Acct. Nos. 701-709) $100,000

When the proceeds of the sale are received by the credit union, they would be recorded as follows:

Dr. - Cash (Acct. No. 731) $100,000
Cr.-Loans Participation
Sold (Contra Account
(Acct. No. 116) $100,000

When the member makes the first payment to the selling credit union:

Dr. - Cash (Acct. No. 731) $3,650.00
Cr.-Interest on Loans
(Acct. No. 111) $2,396.70
Cr.-Other Miscellaneous
Income (Acct. 151) 557.50
Cr.-Loans Participation
Sold (Acct. No. 716) 695.80

The Journal and Cash Record entry to record the payment of a participation remittance received by the ABC Federal Credit Union in Figure 6-3 would be:

Dr. - Loan Participations
Sold (Contra Account)
(Acct. No. 716.1) $347.90
Dr. - Interest On Loans
(Acct. No. 111) 1,198.35
Cr.-Service Income on Loans
Sold and Participations
(Acct. No. 117) $99.87
Cr.-Cash (Acct. No. 731) 1,446.38

When the posting is completed, the balance in the above contra account must reflect the required participation ratio when compared to the Individual Loan Ledger balances for the loan control account and also the report schedule (50% in Figure 6-4). The ending loan balances in the report should also balance to the loans control account.

6030.10 GAINS AND LOSSES ON THE SALE OF PARTICIPATIONS

Even though participation loans are generally sold at par, a gain or loss on the sale may result and must be recognized at the time of sale. When the contract rate of loans sold differs from the yield rate to be paid to the purchaser, there will be a gain or loss on the sale.

6030.10.1 DETERMINING THE GAIN OR LOSS

To determine the gain or loss on the sale of participating interest on loans, two computations are required:

a) Computation of the gross gain or loss; and

b) Computation of the discounts of the gross gain or loss to its present value.

The gross gain or loss is the difference between the selling price and the credit union's cost basis of the participating interest that it sold. "Selling price," as used here, is the same as market price. This would be defined as that price which would have to be paid in the market to obtain a desired yield.

When the purchaser's desired yield is more than the selling credit union's contract rate, the credit union usually has a loss. If the purchaser's desired yield is less than the contracted interest rate, the credit union has a gain. This difference in interest is the gain or loss when discounted to present value.

The examples below illustrate the computation of a gain or a loss. Assume the following facts:

Example #1 (Loss)

CBA Federal Credit Union has $4,000,000 of loans of which it wants to sell a 50% interest to ZYX Federal Credit Union. The note's contracts rate is 12% (US Rule). The interest rate to be paid to the purchaser is 14% (US Rule). The remaining contractual life of the loans sold is 10 years. Assume further that the market price is 91-1/2.

Market Value of Loans Sold	91-1/2%
Par Value of Loans Sold	100%
Discount	8-1/2%
Participating Interest Sold	$2,000,000
Times Discount	x 8 1/2%
Loss	$170,000

Example #2 (Gain)

Assume the same facts in Example #1 except that the market value was 108 1/2 and the contract rate was 12% and the yield to be paid to the purchaser was 11 %. The gain would be $170,000, computed by multiplying 8.5% times $2,000,000.

6030.10.2 DETERMINATION OF MARKET PRICES

The market prices of loans can often be determined by refining to published prices or sales of comparable loans. In many cases, however, it is not possible to obtain market prices in this manner.

When they are not available, an imputed market price must be mathematically computed. The most practical method of determining the unpaved market price is to refer to yield tables for monthly payment loans that can be purchased from various statistical research publishing firms.

6030.10.3 DISCOUNTING THE GROSS GAIN OR LOSS

The gross gain or loss is discounted to present value because the selling credit union does not receive (or pays) the difference in interest (between the contract rate or the yield rate) at the time of the sale. Instead, the credit union receives (or pays) the interest differential over the remaining life of the loans in which the participating interests are sold. This occurs because the credit union collects interest from the borrower at the contract (note's) rate and remits periodically (usually monthly) to the purchaser at the yield rate.

When the credit union experiences a gain on such a sale, it does not have use of all of the funds resulting from it, since the credit union receives a portion of the gain as the premium is amortized (usually monthly).

In the case of a loss (when the contract rate is less than the yield rate), the reverse situation occurs. The credit union has received and is using the funds that will eventually be paid to the purchaser as the discount is amortized over the remaining life of the loans.

Thus in both situations, the gross gain or loss should be discounted to present value to recognize that the cash received, at the time of sale, is not the true selling price.

Using example #2 in Section 6030.10.1, the true selling price was actually $2,170,000. However, at the time of the sale of the credit union only receives $2,000,000. The remaining $170,000 win be paid to the credit union in the form of excess interest as the premium is amortized.

While the credit union will be collecting interest from the borrower at 12%, it will be remitting to the purchaser at 11 %. This 1% differential represents the remaining selling price to be recovered by the credit union. Since the credit union does not have these funds, recognition should be given to this fact by discounting the $170,000 to present value.

In order to discount the gross gain or loss to present value, a rate of interest to use in the discounting computation must be determined. The best approximation of this rate will be the rate at which the sale's proceeds can be reinvested. If the rate selected is the same as the yield to be paid to the purchaser, the gross gain or loss on the sale will remain unchanged. If the rate is not the same, the present value computation must be made.

Assume the following example:

Example #1 (Loss)

ABC Federal Credit Union has $200,000 of loans of which it wants to sell a 50% interest to CBE Federal Credit Union. The rate or contract rate is 7 1/2% (US Rule). The rate (yield) to be paid to the purchaser is 8 1/2%. The average remaining *contractual life* of the loans sold is 240 months while the average remaining life of the loans sold is 60 months.

The ABC FCU's expected rate of return from the funds it receives from the proceeds of the sale is 9%. Servicing costs will be 1/4%. The yield specified in the participation sales agreement was 8-1/4%. Assume that the discount was 4% on the sale (or the loan interest was sold at 96 and the discount totaled $4,000). Using this information the discounted value of the gross loss is computed as follows:

a.	Credit Union's Expected Rate of Return		9%
	Yield to Purchaser		8-1/2%
	*Difference		1/2%
b.	Gross Discount		$4,000
c.	Factor of 1/2% for average remaining life of 60 months**	=	.9884
	Discounted Gross Loss		$3,954

*Yield per sales agreement +1/4% servicing costs.
**Derived by dividing the present value of $1 at 9% for 60 months (48.1733) by the present value of $1 at 8 1/2% for 60 months (48.74118). This results in the stated factor of .9884. Tables can be prepared or purchased to provide this factor.

Example #2 (Gain)

Assume the same facts as in Example #1, above, except that the loan participation interest was sold at 104 or at a premium of 4%. The discounted gross gain would thus be computed in the same manner and would be equal to $3,954.

6030.10.4 ADDITIONAL CONSIDERATION IN DISCOUNTING THE GROSS GAIN OR LOSS

In the foregoing examples, the facts were simply applied. from those that would be present in an actual situation. First, loans of varying interest rates may be included in the package of loans in which participating interests are sold. When this occurs, an average contractual rate needs to be used.

The average interest rate may be determined by computing potential interest (contract rate times principal balance) for each loan in the package. The total potential interest is then divided by the total principal balances which results in the average contract interest rate.

The same reasoning applies to the average recontractual life and estimated remaining life. The package may consist of loans having varying remaining contractual lives and varying estimated remaining lives.

They are averaged using a weighted average method. This means that the principal balances of each loan within the package must be multiplied by its remaining contractual life and estimated remaining life. The sum of the total of each of these calculations must then be divided by the total principal balances. These computations will result in the average remaining contractual life and the average estimated remaining life.

The estimated remaining life of loans sold is a vital factor in computing the gain or loss on a sale. The estimated remaining life should be based on the credit union's past experience with the type of loans being sold. It is possible that the average life on an FHA or VA loan may differ from the conventional loans within the same credit union. All of these factors must be considered in determining the average estimated remaining life, inclusive of mortgage market conditions.

6030.11 CREDIT UNIONS AS SBA GUARANTEED LOAN ORIGINATORS

It has been determined by the SBA that federal credit unions are eligible to become participating SBA lenders under Subsection 120.4(a) of the SBA Rules and Regulations. Before an FCU can make loans under the program an "affirmative determination of eligibility" must be conducted by the district SBA office.

Once this has been accomplished, a loan guarantee agreement can be entered into between the federal credit union and the SBA. Additional information can be obtained at SBA field offices. A complete listing of field offices is available by contacting the Administrator, Small Business Administration, Washington, DC 20416.

Loans originated to members under this program may be held by the credit union or the guaranteed portion may be sold to secondary participants as provided for by the SBA. The sale of the loan would also be subject to requirements of Section 701.23 of the National Credit Union Administration Rules and Regulations (purchase, sale and pledge of eligible obligations). Accounting requirements or transactions of this nature are discussed and outlined in Section 6030.7.

6030.12 SALE OF ASSETS OTHER THAN LOANS INVOLVING A NOTE AS PAYMENT

In this section thus far, loans have been used in the computations. The same accounting theory and practice would apply to other assets, particularly when an asset, such as a computer, would be sold and paid for by the buyer with a note to the credit union plus cash. The interest rate method of computing interest should be used.

Illustration

On January 1, 19X0, HEM FCU sells a computer to RAM FCU which originally cost $600,000. It has total depreciation of $300,000. RAM FCU gave HEM FCU a noninterest bearing note of $400,000 in payment. The note was payable 3 years later. Assume that current interest rate for the first and second year would be as illustrated below:

January 1, 19X0.

Dr. - Notes and Contracts Receivable (Acct. No. 711)	$400,000	
Dr. - Allowance for Depreciation of Furniture and Equipment (Acct. No. 775)	300,000	
Cr.-Furniture and Equipment (Acct. No. 774)		$600,000
Cr.-Gain (Loss) on Deposition of Assets (Acct. No. 430)		17,532
Cr.-Unamortized Discount on Sale of Assets (Acct. No. 886)		82,468

Computation of Gain or Loss on Disposition

Step #1 Note	x	Present value factor for 8% for 3 periods	=	$317,532
$400,000	x	.79383		

Step #2 Note	-	Discount Present Value	=	Unamortized Discount
$400,000	-	$317,532		$82,468

Step #3: Compute resulting Gain or Loss $400,00-($600,000 - $300,000)-$82,468 = $17,532

Computation and Recording of Interest Income December 31, 19x0:

Step #1:

Discounted PV x Current Interest Rate = Interest Income.

$317,532 x 8% = $25,402.56

Step #2 Entry:

Dr. - Unamortized Discount on
Sale of Assets (Acct. No. 886) $25,402.56
Cr.-Other Nonoperating
Income (Acct. No. 440) $25,402.56

December 31, 19X1:

Step #1: Discounted Present Value of Note, 12/31/x0, + Discount Amortization, 12/31/x0, x Current Interest Rate at Time of Sale = Interest Income

$317,532 + $25,402.56 = $342.934.56 x 8% = $27,434.76

Step #2: Entry:

Dr. - Unamortized Discount on
Sale of Assets (Acct. No. 886) $27,434.76
Cr.-Other Nonoperating
Income (Acct. No. 440) $27,434.76

6030.13 ACCOUNTING FOR PROFIT RECOGNITION ON SALES OF REAL ESTATE

A credit union's profit on a real estate loan should only be immediately recognized when the following two conditions exist:

a) collectibility of the sales price is reasonably assured or the amount that would be uncollectible can be estimated; and

b) the credit union is no longer committed to performing additional acts subsequent to the sale. Unless both conditions exist, recognition of all or part of the profits shall be postponed.

To recognize profit on the full accrual basis, all of the following conditions must be met:

a) A sale is consummated.

b) The buyer's initial and continuing investments are adequate to demonstrate a commitment to pay for the property.

c) The seller's receivable is not subject to future subordination.

d) The seller has transferred to the buyer the usual risks and rewards of ownership in a transaction and does not have a substantial continuing involvement with the property.

A sale must be consummated before profit can be recognized. Consummation consists of binding the selling credit union and the purchaser to the terms of the sales contract, exchanging all consideration (payment), arranging any permanent financing for which the seller is responsible, and completing all acts that are subject to the sale. Generally, all of these acts are completed at the time of closing (upon settlement) and not when the sales contract is completed.

The buyer's initial investment should be adequate to ensure his commitment to pay for the property and evidence a reasonable likelihood that the seller will collect the receivable. Its adequacy shall be determined by its composition and its size compared with the sales value of the property. It shall include:

a) cash paid as a down payment,

b) the buyer's notes supported by irrevocable letters of credit from an independent lending institution,

c) payments to third parties to reduce existing indebtedness on the property, and

d) other amounts paid that are part of the sales value.

The initial investment shall not include:

a) payments made by the buyer to third parties for improvements to the property,

b) a permanent loan commitment by an independent third party to replace a loan made by the seller,

c) any funds that have been or will be loaned, refunded, or directly or indirectly provided to the buyer by the seller or loans guaranteed or collateralized by the seller for the buyer.

A table of minimum initial investment expressed as a percentage of sales value as represented in FAS66, paragraph 54 is provided in Figure 6-5.

To evidence a continuing investment, the buyer must be contractually required to pay annually an amount at least equal to the level annual payment that would be needed to pay that debt and interest on the unpaid balance over no more than 20 years for land and the customary mortgage term by an independent established lending institution for other real estate.

The restriction on future subordination shall not apply under either of two conditions:

a) a receivable is subordinate to a first mortgage on the property existing at the time of sale, or
b) a future loan, including an existing permanent loan commitment, is provided for by the terms of the sale and the purchase of the loan will be applied first to the payment of the seller's receivable.

FIGURE 6-5

	Minimum Initial Investment Expressed as a Percentage of Sales Value
Land	
Held for commercial, industrial, or residential development to commence within two years after sale	20
Held for commercial, industrial, or residential development to commence after two years	25
Commercial and Industrial Property	
Office and industrial buildings, shopping centers, and so forth:	
Properties subject to lease on a long-term lease basis to parties with satisfaction credit rating; cash flow currently sufficient to service all indebtedness	10
Single-tenancy properties sold to a buyer with a satisfactory credity rating	15
All other	20
Other income-producing properties (hotels, motels, marinas, mobile home parks, and so forth):	
Cash flow currently sufficient to service all indebtedness	15
Start-up situtations or current deficiencies in cash flow	25
Multifamily Residential Property	
Primary residence:	
Cash flow currenctly sufficient to service all indebtedness	10
Start-up situtations or current deficiencies in cash flow	15
Secondary or recreational residence:	
Cash flow currently sufficient to service all indebtdness	15
Start-up situations or current deficiencies in cash flow	25
Single-Family Residential Property (including condominium or cooperative housing)	
Primary residence of the buyer	5[a]
Secondary or recreational residence	10[a]

Examples of forms of involvement that result in retention of substantial risks or rewards by the seller include:

a) seller's obligation or option to repurchase the property,
b) the seller is a general partner in a limited partnership that acquires an interest in the property sold and holds a receivable from the buyer for a significant part of the sales price,

c) the seller guarantees the return in whole or in part of the buyer's investment,
d) the seller is required to initiate or support operations or continue to operate the property at its own risk for a period of time, the transaction is merely an option to purchase,
e) the sale is only a partial sale,
f) the seller sees improvements and leases the underlying land,
g) the sale of the property is accompanied by a leaseback to the seller, etc.

SFAS No. 66 requires that if the seller has some continuing involvement with the property and does not transfer substantially all of the risks and rewards of ownership, profit should be recognized by a method determined by the nature and extent of the seller's continuing involvement. Generally, if the amount of a seller's loss of profit is limited because of continued involvement by the terms of the sales contract, profit should be recognized at the time of sale. The profit recognized must be reduced by the maximum exposure to loss.

6030.14 METHODS OF RECOGNIZING PROFIT ON THE SALE OF REAL ESTATE

The three methods of profit recognition on the sale of real estate are as follows:

a) Deposit Method: Postpones recognition of a sale until a sale is realized. Until a sale has been recognized, the credit union records a receivable and not profit. The property is still recorded as though the credit union owned it. Cash received is recorded only as a deposit liability (Accounts Payable).

b) Cost Recovery Method: Accounts for all cash received as a recovery of cost. No profit is recognized, until the cost of the property has been collected. Thereafter, all collections are accounted for as profit is received.

c) Installment Method: Apportions each cash payment received between the recovered cost and the profit to be recognized in the same ratio as cost and profit are assumed to constitute sales price. A sales contract is not a sale, for accounting purposes, if the credit union retains the risks of ownership.

For example, if the credit union agrees to or has an obligation to repurchase the property at a specified date, the transaction, in substance, is not a sale. Nor is it a sale if the buyer can cause the seller (credit union) to repurchase the property, or if the credit union guarantees the return of the buyer's investments. "No sale is recognized if the transaction is in substance a financing, leasing, or profit-sharing arrangement."

6040 MORTGAGE BANKING ACTIVITIES

A credit union acts in the capacity of a mortgage banker and engages in mortgage banking activities when it: (a) originates or acquires mortgage loans for sale to permanent investors and (b) subsequently provides long-term servicing of the loans. See Section 6030 of this manual for a discussion on the purchase and sale of eligible member obligations including mortgage loans.

Mortgage loans and mortgage-backed securities held for sale should be reported at the lower of cost or market value on the credit union's financial statements. The amount by which cost exceeds market should be accounted for as a valuation allowance and changes in the valuation allowance should be included in the determination of net income for the period in which the changes occurs.

Purchase discounts on mortgage loans and mortgage-backed securities should not be amortized as interest revenue during the period the loans or securities are held for sale. On the financial statements, a credit union should distinguish between (a) mortgage loans and mortgage-backed securities held for sale and (b) mortgage loans and mortgage-backed securities held for long-term investment.

6040.1 LONG-TERM SERVICING

6040.1.1 DEFINITIONS

Current (normal) servicing fee rate. A servicing fee rate that is representative of the servicing fee rates most commonly used in comparable servicing agreements covering similar types of loans. Determination of the normal servicing rate typically requires consideration of customary rates in the secondary market.

Net servicing income. The estimated future servicing revenue less the expected future servicing costs; comparison based on present value analysis.

Servicing. Servicing includes collecting monthly payments, forwarding payments and related accounting reports to investors, collecting escrow deposits, and paying necessary taxes and insurance from escrow funds.

Servicing rights. When loans are sold, the seller often retains the right to service the loans for the buyer for a fee. When these servicing fees exceed the cost of performing the servicing functions, the servicing rights have economic value (an intangible asset). Because of this value, servicing rights are frequently purchased and sold.

6040.1.2 SERVICING INTERNALLY GENERATED LOANS

Servicing rights for internally generated loans are recorded as a separate asset even if the underlying loans are sold to an investor. If the servicing fee stated in the sales agreement differs materially from the current (normal) servicing fee rate, the sales price should be adjusted so that servicing income is properly recognized in subsequent years. The adjustment is the difference between the actual selling price and the estimated selling price if a normal servicing rate were specified. The difference is recognized as an adjustment to the gain or loss on the sale. Additionally, if normal servicing fees are expected to be less than estimated servicing costs, a loss on servicing should be accrued at the time of sale.

a) Credit union sells $450,000 of member loans for $475,000 cash. The credit union agrees to continue servicing the loans for twice the normal servicing fee rate. If the credit union had consented to service the loan for the normal servicing fee rate, the selling price would have been $500,000. The gain on the sale is computed as follows:

Actual selling price	$475,000	
Principal balance of loans sold	450,000	
Initial gain		$25,000
Adjusted selling price (normal fee)	$500,000	
Actual selling price (excess servicing)	475,000	
Excess servicing adjustment		25,000
Total gain on sale		$50,000

Dr. - Cash (Acct. No. 730)	$475,000	
Dr. - Other Accrued Income (Acct. No. 789)	25,000	
Cr.-Loans (Acct. No. 701)		$450,000
Cr.-Gain on Sale of Loans (Acct. No. 140)		50,000

b. Credit union sells $450,000 of member loans for $400,000 cash. The credit union agrees to continue servicing the loans for twice the normal servicing fee rate. If the credit union had consented to service the loan for the normal servicing fee rate, the selling price would have been $425,000. The gain/loss on the sale is computed as follows:

Actual selling price	$400,000	
Principal balance of loans sold	450,000	
Initial loss	($50,000)	
Adjusted selling price (normal fee)	$425,000	
Actual selling price (excess servicing)	400,000	
Excess servicing adjustment		25,000
Total loss on sale		($25,000)

Dr. - Cash (Acct. No. 730)	$400,000	
Dr. - Loss on Sale of Loans (Acct. No. 140)	25,000	
Dr. - Other Accrued Income (Acct. No. 789)	25,000	
Cr.-Loans (Acct. No. 701)		$450,000

In both examples, the total gain/loss on the sale includes the amount of excess servicing. The full amount of the gain/loss is recognized at the time of sale so that servicing income is not distorted for the servicing period.

c) The credit union's total servicing income for a given period is $1,000, of which half is determined to excess servicing accounted for at the time of the sale. The following entry records the amount of servicing income, reduced by the amount of excess servicing:

Dr. - Cash (Acct. No. 730)	$1,000	
Cr. - Other Accrued Income (Acct. No. 789)		$500
Cr. -Income from Loans (Acct. No. 110)		500

6040.1.3 SERVICING PURCHASED LOANS

A credit union that acquires mortgage servicing rights (it is impermissible for credit unions to purchase mortgage servicing rights without the underlying loans) and sells or securitizes those loans while retaining the serving rights, should allocate the total cost of the mortgage loans between the servicing rights and the loans (without the servicing rights). The allocation should be based on their relative fair values if it is practicable to estimate those fair values. If the fair values of the mortgage servicing rights and the mortgage loans (without the servicing rights) cannot be estimated, the entire cost of purchasing or originating the loans should be allocated to the mortgage loans, as is currently done.

A credit union should arrange its mortgage servicing rights that are capitalized based on one or more of the predominant risk characteristics of the underlying loans, e.g., loan type, size, note rate, date of origination, term, and geographic location. Impairment should be recognized through a valuation allowance for each impaired category.

Illustrative Entries

Credit union purchases loans for $750,000 cash, including related servicing rights. The price without the related servicing rights would have been $475,000. The loans were immediately sold to an outside investor for $500,000. The present value of the net servicing income is estimated to be $300,000. The value of the servicing rights is computed as follows:

Purchase price of loans with servicing	$750,000	
Purchase price of loans without servicing	475,000	
Cost of servicing rights	$275,000	
Dr. - Loans (Acct. No. 701)	$475,000	
Dr. - Investment-Servicing Rights (Acct. No. 470)	275,000	
Cr.-Cash (Acct. No. 730)		$750,000

This entry records the acquisition of the loans and the servicing rights for cash. The value of the servicing rights is determined to be the difference between the purchase price of the loans with and without servicing. The servicing rights are recorded at the lower of cost or present value of net servicing income.

Dr. - Cash (Acct. No. 730) $500,000

Cr.-Loans (Acct. No. 701) $475,000

Cr.-Gain on Sale of Loans
(Acct. No. 140) 25,000

This entry records the sale of the loans and recognizes the gain on the sale.

6050 CREDIT CARDS

Section 107(5)(B) of the Federal Credit Union Act gives the board of directors of a federal credit union the authority to implement a credit card lending program for the credit union members.

Some of the issues which the board will need to consider prior to making a decision include:

a) Do the members desire this type of program and will they use it?

b) What are the economic costs of the program and can the credit union afford to provide the service?

c) Will the credit union establish its own program, participate with other credit unions or financial institutions in establishing a program, or join an existing program such as the national bank programs, which may be directly affiliated with a bank or through another vendor (VISA, Master Card, etc.)?

In addition to these general issues, the board of directors must be familiar with the provisions of Part 701.21 of the National Credit Union Administration Rules and Regulations, the provisions of Regulation Z, and the operation of existing credit card systems. With this general background the board of directors will have a point from which to start in making an informed and realistic decision concerning the establishment of a credit card program.

Prior to implementing a credit card program, the board of directors should obtain a written legal opinion regarding the legal propriety of their credit card program.

A federal credit union may enter into an agency relationship with a bank or other financial institution to provide another financial institution's credit cards to the credit union's members provided:

a) The federal credit union's management is free to make its own credit decision on each member's credit application.

b) All loans or advances made to the federal credit union's members under the credit card program will be extended under the provisions of Section 107(5)(B) of the Federal Credit Union Act.

A federal credit union may issue credit cards to its own members. The board may include, as part of its credit card policy, a policy where joint account owners, cosigners and nonmembers may be issued credit cards. Issuance of cards to other than regular credit union members could occur only if:

a) The board policy permits it;

b) The primary account holder (primary credit union member) desires it;

c) The sponsoring member's request must be in writing;

d) The member's line of credit account number must appear on the face of the credit card;

e) The issuance of any additional cards to a member or to other persons must comply with specific written policies established by the board of directors; and

f) The member must be primarily liable to the issuing credit union for any nonmember (authorized user) purchases or advances made pursuant to use of the credit card.

Within the limits of the Act and NCUA Rules and Regulations, the board of directors will establish written loan policies for line of credit loans.

Each line of credit loan will be evidenced by an agreement which will contain, incorporate by reference, or provide for at least the following:

a) The borrower's credit limit or maximum amount of principal available under the agreement;

b) The schedule of payments required to repay the loan;

c) The interest rate or rates, not exceeding the maximum rate, inclusive of all service charges, allowed by the Act;

d) The borrower's promise to repay;

e) The repayment of any amount outstanding, prior to maturity, without penalty;

f) Other conditions established by the board of directors necessary to protect the credit union and comply with applicable Federal and State laws and regulations; and

g) That the credit committee or loan officer may terminate the agreement under the following conditions:

   1) Upon adverse reevaluation of the borrower's creditworthiness.

   2) Upon failure of the borrower to satisfy the terms of the agreement.

3) At the option of the borrower or the credit union with good cause.

The termination of a line of credit agreement by the credit union will be given by written notice and will be in accordance with the Equal Credit Opportunity Act and Regulation B.

The board of directors may, as part of their policy, require a review of the members' loan files on a periodic basis (i.e., every 36 months, or other period) to determine the continuing creditworthiness of the members.

The review will be completed by obtaining current information to reassess the member's creditworthiness and the date of the review will be documented in the member's loan file.

A reapplication by the member and approval by the credit committee should be required when the member's credit limit is increased, or when the terms of payment are extended beyond the terms of the original agreement.

Liquidity Considerations

The credit union's liquidity status, in relation to extending loans approved under line of credit agreements, should be reviewed by the board of directors each month. This review should be documented by recording the following information, as of the previous month end, in the board of directors' minutes:

a) The number and amount of outstanding balances under all line of credit agreements;

b) The aggregate amount of credit approved under line of credit agreements; and

c) The total amount of loans advanced and the total amount of loans repaid under line of credit agreements for the previous month.

This monthly review will enable the board of directors to monitor the credit union's liquidity needs and minimize the likelihood of the contingent liabilities exceeding the credit union's available liquid assets.

The board of directors should establish a policy for control of advances disbursed under a line of credit agreement which exceed the borrower's credit limit.

Regulation Z, Truth-in-Lending Act

The credit union must comply with the provisions of Regulation Z when any open-end credit plan is offered to members. This includes credit card plans.

Sections 226.5 through 226.16 of Regulation Z pertain to open-end credit, including sections on periodic statements, billing error resolution procedures and a special credit card provisions section. The Board of Directors should be knowledgeable of the requirements of this regulation if a credit card or other open-end plan is offered.

Regulation E, Electronic Funds Transfer Act

Certain provisions of Regulation E apply when a credit card is used to initiate an electronic funds transfer. If the credit union issues credit cards which can be used to obtain cash advances from an ATM (automatic teller machine), the credit union will need to comply with Regulation E.

6050.1 INTEREST COMPUTATION

Each federal credit union must determine that the computation used for determining the interest due at each billing date for a credit card program does not exceed the maximum interest rate permitted by the Federal Credit Union Act. The following factors need to be considered in determining the propriety of the amount of interest charged to the member:

a) Interest must be calculated on the unpaid principal balance after credit is given for all payments and adjustments during the beginning period. The adjusted balance and average daily balance methods of interest computation may be used. The previous statement of account balance method of interest computation is not allowed.

b) When included with interest charges, fees such as cash advance fees, fees assessed when any balance is outstanding, or other fees related to the extension of credit, may not exceed the maximum rate of interest permitted by the Federal Credit Union Act. Fees not included for the purposes of the usury limit would be an annual card fee, the initial card issuance fee, annual high balance fees (over the credit limit fees), or charges which are assets whether or not the card is used to obtain credit. (Reference Section 226.4 of Regulation Z for descriptions of finance charges and charges which are excluded from the finance charge.)

c) Interest may not begin to accrue prior to the date of a cash advance or the date of purchase if posted (debited) to the member’s account.

d) The board of directors may establish a reasonable grace period not exceeding 30 days and waive interest charges accruing from the beginning date (date bill is prepared) to the date payment is posted (debited) to the member’s account.

e) A fee may be assessed against a member if the member exceeds the approved line of credit (referred to as annual high balance fee).

6050.2 ACCOUNTING AND OPERATIONAL POLICY

For the most part, the same instructions concerning closed-end loans are still appropriate when dealing with a credit card program; however, the following modifications in the accounting and operational policy are necessary:

a) “Lines of Credit to Members-Credit Cards,” (Account No. 702.6) should include all outstanding balances advanced under line of credit agreements. Additional segregation’s of this account may be used for credit card accounts.

b) “Interest on Lines of Credit,” (Account No. 112) should be used to record interest received on outstanding line of credit balances.

c) “Deferred Credits-Credit Card Commitments,” (Account No. 884): Fees which are periodically collected from cardholders, such as annual credit card fees, should be recorded as deferred credits and amortized over the period to which they apply.

   Account No. 884, “Defended Credits-Credit Card Commitments”, should be used to record the deferred fee income; the fees should be amortized through Account No. 162, “Service Income on Credit Card Loans”. (Refer to illustrative entries in Section 4050 of this Manual, Account No. 884.)

d) Appropriate expenses incurred in the operation of a credit card program need to be charged to “Credit Card Program Expenses,” (Account No. 286). Any interchange fees received should be recorded under “Credit Card Interchange Income,” (Account No. 152).

e) The aggregate total of credit limits approved for members should be noted on the Statement of Financial Condition, Form FCU 109A, as a contingent liability at the end of the month.

f) Delinquency for line of credit loans is computed on a contractual basis by comparing the amount of the minimum payment billed to the amount paid by the member prior to the next billing statement. Any portion of a billed minimum payment which is not paid by the next billing period will cause the unpaid balance to be considered delinquent.

   Payments received on delinquent accounts should be applied to delinquent minimum payments starting with the oldest delinquent payment. If payment of a delinquent minimum payment is not received by the third beginning date, the unpaid balance is considered to be 2 months delinquent. In no case should payment in excess of the minimum payment cause the account to be paid ahead or reduce the amount of subsequent required monthly payments.

g) Form FCU 118, Schedule of Delinquent Loans, may also be used as a substitute to report delinquent account activity for lines of credit. The form can be modified by retitling column (3) to “Approved Credit Limit,” column (4) to “Amount of Payments in Arrears,” and the identification heading for columns (5) through (8) to “Unpaid Balances of Delinquent Line of Credit.” Four categories of delinquent line of credit balances should be reported in columns (5) through (8) including “l to less than 2 months,” “2 to less than 6 months...... 6 to less than 12 months,” and “ 12 months and over.” The date of last payment can be reported in column (9). Forms FCU 118 or 118 LC are completed for line of credit loans as of the monthly billing date or at the end of each month. Substitute forms may be used if the information included on modified Form FCU 118 LC is provided.

   It is recommended that federal credit unions establishing credit card programs limit payment schedules to 3 years in order to assimilate that sufficient turnover of funds occurs to provide liquidity. Credit limits established and a members’ ability to repay should be carefully reviewed to determine each credit(ht union’s ability to meet the demands placed upon it by its members.

Figure 6-6: Illustration of a Completed Schedule of Dlinquent Lines of Credit (Form FCU 118 LC)

(FORM FCU 118 LC)

OUR
Federal Credit Union

SCHEDULE OF DELINQUENT LINES OF CREDIT

AS OF December 31, 1980 .

SUMMARY

DELINQUENT CATEGORIES	NUMBER	UNP BALANCES
1 TO Less than 2 Months	4	387 00
2 TO Less Than 6 Months	1	563 30
6 To Less Than 12 Months	1	1058 20
12 Months And Over		
Totals		

(1) ACCOUNT NUMBER	(2) NAME OF BORROWER	(3) APPROVED CREDIT LINE	(4) AMOUNT OF PAYMENTS IN ARREARS	(5) UNPAID BALANCES OF DELINQUENT LINES OF CREDIT: 1 To Less Than 2 Months	(6) 2 TO Less Than 6 Months	(7) 6 To Less Than 12 Months	(8) 12 Months and over	(9) DATE OF LATE PAYMENT	COMMENTS
13	Mary Jones	2000 00	200 00	125 00				11/30/80	Sick-now pays weekly
133	Lawrence Hart	2000 00	200 00	90 00				11/30/80	Promised Pymt. 1/15/81
220	Stanley Mark	750 00	30 00		563 00			9/30/80	Out of city
241	Bill Burns	1400 00	1200 00			1058 20		1/31/80	Sick - Have contact
297	W. A. Giles	3000 00	300 00	130 00				11/30/80	Slow pay at times
369	Peter Mckinley	500 00	50 00	42 50				11/30/80	Will catch up next week
TOTAL UNPAID BALANCES OF DELINQUENT LOANS				387 50	563 30	1,058 20			
TOTAL NUMBER OF DELINQUENT LOANS				4	1	1	0		

In most cases, credit unions which intend to offer a credit card program will utilize one of the existing bank programs, e.g., VISA, Master Card, etc. Generally, these existing programs use the "batch system" concept in maintaining the records of member credit card transactions. In a "batch system" program the data processor maintains the member's account activity and periodically, e.g., weekly, submits this information to the credit union for entry on its records. Adjustments that may be needed should be recorded in an in-process account which should be reconciled monthly. The accounting entries listed below are recorded in the "Miscellaneous" columns of the Journal and Cash Record (Form FCU 101).

Accounts used relating to credit card programs:

Account No.	Title
112.0	Interest on Lines of Credit
152.0	Credit Card Interchange Income
162.0	Service Income on Credit Card Loans
286.0	Credit Card Program Expenses
702.4	Lines of Credit-Cash Advances in Process
702.6	Lines of Credit to Members-Credit Cards
783.0	Accrued Credit Card Income
730 or 740	Settlement Account (as described in Section 6050.3.1 Series)
802.1	Credit Card Payments in Process
802.2	Credit Card Adjustments in Process
802.3	Credit Card Chargebacks in Process
884.0	Deferred Credits-Credit Card Commitment Fees

6050.3 ACCOUNTING FOR CREDIT CARD TRANSACTIONS

Monetary activity affecting credit union member cardholder account balances can be originated either by the credit union or by other merchants or financial institutions that participate in the credit card program The credit union's General Ledger accounting entries have to take into account both in-process items submitted by the credit union and the processor's posting from other sources.

The credit union's employees forward batches of cash advances, adjustments or payments. The batch total dollar amounts for each type of input are placed into an in-process account called "Lines of Credit Cash Advances in Process," (Account No. 702.4). When they are posted to the cardholder's account, the amounts are transferred from this in-process account to "Lines of Credit to Members-Credit Cards," (Account No. 702.6). Processor rejects are sold back to the credit union.

This in-process accounting involves suspending all credit union monetary input until the processor's reports are received and showing either posting or rejection of the input. It also considers the accrual of interest billed and the applying of payments received to principal and interest.

6050.3.1 ILLUSTRATIVE ENTRIES

a) Settlement Account.

Some of the following entries affect a credit card settlement account, an asset account which may be established as:

- A Cash Account in a commercial bank, established as a separate General Ledger account in the 730 account series (i.e., any unassigned Cash Account from Account No. 732 through Account No. 737);

- A deposit in another credit union, "Shares/Deposits/Certificates of Other Credit Unions," (Account No. 745). (The settlement account should be established separately from other accounts, if any, in the 745 series, i.e., Account No. 745.1, 745.2, etc.); and

- A deposit in a corporate credit union, "Shares/Deposits/Certificates of Corporate Credit Unions," (Account No. 744). (The settlement account should be established separately from other accounts, if any, in the 744 series, i.e., Account No. 744.1, 744.1, etc.)

For illustrative purposes, the settlement account used below is Account No. 745, "Shares/ Deposits/ Certificates of Other Credit Unions". If another settlement account is used, the appropriate account number would be substituted in place of Account No. 745.

The settlement account should be reconciled at the end of each month with the appropriate General Ledger account.

a) To record periodic transfers to the settlement account:

Dr. - Corporate Credit Unions (Acct. No. 744) or Commercial Bank Deposits (Acct. No. 746.1) or Savings and Loans and Mutual Savings Bank Deposits (Acct. No. 746.2)	$1,000	
Cr.-Cash (Acct. No. 731)		$1,000

b) To record purchase of sales drafts and cash advances from processor:

Dr. - Lines of Credit to Members
Credit Cards (Acct. No. 702.6) $950
Cr.-Corporate Credit Unions
(Acct. No. 744) or Commercial
Bank Deposits (Acct. No.
746.1) or Savings and Loans
and Mutual Savings Bank
Deposits (Acct. No. 746.2) $950

c) To record periodic payment of vendor’s expenses through the settlement account:

Dr. - Credit Card Program
Expense (Acct. No. 286) $50
Cr.-Corporate Credit Unions
(Acct. No. 744) or Commercial
Bank Deposits (Acct. No.
746.1) or Savings and Loans
and Mutual Savings Bank
Deposits (Acct. No. 746.2) $50

d) To record monthly receipt of the Interchange income:

Dr. - Corporate Credit Unions
(Acct. No. 744) or Commercial
Bank Deposits (Acct. No. 746.1)
or Savings and Loans and
Mutual Savings Bank Deposits
(Acct. No. 746.2) $980
Cr.-Credit Card Interchange
Income (Acct. No. 152) $980

e) To record payments received by processor through a lock box:

Dr. - Corporate Credit Unions
(Acct. No. 744) or Commercial
Bank Deposits (Acct. No. 746.1)
or Savings and Loans and
Mutual Savings Bank Deposits
(Acct. No. 746.2) $950
Cr.-Lines of Credit to Members -
Credit Cards (Acct. No. 702.6) $800
Cr.-Accrued Credit Card
Income (Acct. No. 783) 150

*****NOTE: If settlement is performed through a corporate central credit union then the settlement account number would be 744.1., "Shares, Deposits of Corporate Central Credit Unions - Credit Card Settlement". The settlement account should be reconciled at the end of each month with the balance in the General Ledger.

Cash Account Entries.

a) To record periodic payment of credit card expenses through cash account:

Dr. - Credit Card Program Expense (Acct. No. 286)	$170	
Cr.-Cash (Acct. No. 731)		$170

Credit Union Cash Advance.

a) To record cash advances at the credit union office:

Dr.-Lines of Credit-Cash Advances in Process (Acct. No. 702.4)	$150	
Cr.-Cash (Acct. No. 731)		$150

b) To record posting of cash advances by the processor:

Dr.-Lines of Credit to Members-Credit Cards (Acct. No. 702.6)	$150	
Cr.-Lines of Credit - Cash Advances in Process (Acct. No. 702.4)		$150

Payments to the Credit Union.

a) To record billed interest calculated by the processor and added to members' monthly statements:

Dr.-Accrued Credit Card Income (Acct. No. 783)	$775	
Cr.-Interest on Lines of Credit (Acct. No. 112.2)		$775

b) To record Credit Card payments received at the credit union office:

Dr.-Cash (Acct. No. 731)	$475	
Cr.-Credit Card Payments in Process (Acct. No. 802.1)		$475

c) To record posting of payments by the processor:

Dr.-Credit Card Payments in
Process (Acct. No. 802.1) $475
Cr.-Lines of Credit to Members -
Credit Cards (Acct. No. 702.6) $453
Cr.-Accrued Credit Card
Income (Acct. No. 783) 22

Adjustments Generated by the Credit Union.

a) To record credit union initiated adjustments, when the processor erroneously posts a credit transaction to a wrong member's account:

Dr.-Credit Card Adjustments in
Process (Acct. No. 802.2) $478
Cr.-Lines of Credit to Members -
Credit Cards (Acct. No. 702.6) $478

b) When the processor posts the payment to the correct member's account:

Dr.-Lines of Credit to Members -
Credit Cards (Acct. No. 702.6) $478
Cr.-Credit Card Adjustments
in Process (Acct. No. 802.2) $478

NOTE: An adjustment for interest would also have to be made if erroneously posted to the wrong member's account.

Chargeback Accounting Initiated by the Credit Union.

a) When the credit union personnel initiates a chargeback and adjustment to a cardholder's loan account for a sales draft that was charged to the account in error:

Dr.-Credit Card Chargeback in
Process (Acct. No. 802.3) $275
Cr.-Credit Card Adjustments in
Process (Acct. No. 802.2) $275

b) Then, when the adjustment is posted:

Dr.-Credit Card Adjustments in
Process (Acct. No. 802.2) $275
Cr.-Lines of Credit to Members -
Credit Cards (Acct. No. 702.6) $275

c) It will then need to be accompanied by an adjustment of the finance charge by:

Dr.-Interest on Lines of Credit - Credit Cards (Acct. No. 112.2)	$2.75	
Cr.-Credit Card Adjustments in Process (Acct. No. 802.2)		$2.75

d) The credit union will receive an advice of credit for the sales draft chargeback. Thus,

Dr.-Credit Card Interchange Income (Acct. No. 152)	$1	
Dr.-Corporate Credit Unions (Acct. No. 744) or Commercial Bank Deposits (Acct. No. 746.1) or Savings and Loans and Mutual Savings Bank Deposits (Acct. No. 746.2)	275	
Cr.-Credit Card Chargeback in Process (Acct. No. 802.3)		$276

Chargeback Reversal.

a) When the credit union has received an Advice of Charge and the chargeback documentation:

Dr.-Credit Card Chargeback in Process (Acct. No. 802.3)	$276	
Cr.-Credit Card Interchange Income (Acct. No. 152)		$1
Cr.-Corporate Credit Unions (Acct. No. 744) or Commercial Bank Deposits (Acct. No. 746.1) or Savings and Loans and Mutual Savings Bank Deposits (Acct. No. 746.2)		275

b) When the credit union prepares the adjustment documentation to charge the cardholder:

Dr.-Credit Card Adjustments in Process (Acct. No. 802.2)	$275	
Cr.-Credit Card Chargebacks in Process (Acct. No. 802.3)		$275

c) When the item is posted to the cardholder's account:

Dr.-Lines of Credit to Members -
Credit Cards (Acct. No. 702.6) $275
Cr.-Credit Card Adjustments in
Process (Acct. No. 802.2) $275

Credit Union Adjusting Entries.

a) To establish or increase the Allowance for Loan Losses for Credit Card losses:

Dr.-Provision for Loan Losses-Lines
of Credit (Acct. No. 302) $4,000
Cr.-Allowance for Loan Losses -
Lines of Credit (Acct. No. 719.2) $4,000

b) To record charge-off of a Credit Card (Line of Credit) loan principal and to reverse the accrued interest income:

Dr.-Allowance for Loan Losses-Lines
of Credit (Acct. No. 712.2) $550
Dr.-Interest on Lines of Credit - Credit
Cards (Acct. No. 112.2) 110
Cr.-Lines of Credit to Members -
Credit Cards (Acct. No. 702.6) $550
Cr.-Accrued Credit Card Income
(Acct. No. 783) 110

6050.4 TRIAL BALANCE

The vendor or processor will normally provide the card issuing credit union with a monthly trial balance of all cardholder accounts. The date of the trial balance coincides with the date of the monthly statement. If the credit union's statement date is other than month-end, the federal credit union's Journal and Cash Record and General Ledger is posted and totaled as of the date of the monthly cardholder trial balance and a trial balance must be taken of the General Ledger. Any differences between the cardholder trial balance and the General Ledger's Lines of Credit to Members - Credit Cards (Account No. 702.6) are located and corrected within 7 days after the trial balance is received.

6050.5 INTERNAL CONTROLS

The board of directors of a federal credit union which issues credit cards should establish sufficient internal controls to assure that improper use of a credit card is quickly detected. Some credit unions may involve themselves with existing credit card programs which already contain many of the controls for issuing credit cards. The officials and management of a credit union should be fully aware of how these systems operate. Management will need to implement daily audit and review routines to assure that the established controls and systems are functioning properly. The board of directors may wish to purchase insurance coverage, from the bonding company, for protection from losses due to cardholder fraud.

6060 INVESTMENTS

This section discusses investments and accounting for investments. In general, investments are limited to those authorized by Section 107 of the Federal Credit Union Act (the Act) and Part 703 of the National Credit Union Administration Rules and Regulations. Rather than repeat the section and part here, we refer you to the above referenced documents for examples of the types of investments permissible for federal credit unions.

6060.1 METHOD OF RECORDING INVESTMENTS

When a credit union acquires securities, it must assess its intent and ability with regard to its securities holdings and assign its debt and equity securities to the appropriate measurement category: *trading, held-to-maturity,* or *available-for-sale*. Not less frequently than the end of each dividend period, (i.e., monthly, quarterly, semiannually, or annually), the appropriateness of the classifications, and the reasonableness and accuracy of the related measurement (*trading* and *available-for-sale*) shall be assessed.

Reporting requirements shall be as follows:

- *Debt and equity* securities that are bought and held principally for the purpose of selling them in the near term shall be classified as *trading securities* and reported at fair value through the income statement.

- *Debt* securities (not equity) that the enterprise has the positive intent and ability to hold to maturity shall be classified as securities *held-to-maturity* and reported at amortized cost.

- *Debt and equity* securities not classified as either securities *trading* or *held-to-maturity* securities shall be classified as securities *available-for-sale* and reported at fair value through a separate component of equity in the balance sheet, *Accumulated Unrealized Gains/Losses on Available-for-Sale Securities.*

For credit union boards, in particular, fair value measurement gives them the information they need to oversee their credit unions. If securities in the *available-for-sale* portfolio drop in fair value below book value, a credit union board will have a ready indicator of this decline in the balance sheet separate equity account. These losses are *real* losses which are simply unrealized. Fair value measurement is a tool credit union management, credit union boards, and regulatory staff need to ensure the safety and soundness of credit unions, individually and corporately.

A credit union shall consider GAAP in how it plans to manage its holdings of securities when designating individual securities as trading, *held-to-maturity* or *available-for-sale*. Credit unions which used outside accountants are encouraged to consult them when assigning their securities to the measurement categories. There is no specified percentage or amount of securities that a credit union must assign to each category. Rather, the amount of securities a credit union assigns to each of the three categories depends on the facts and circumstances surrounding the credit union and the actual securities it owns.

A credit union shall have adequate documentation to support the initial assignment of securities to the three categories, the assignments made when securities are purchased, and the periodic evaluations (not less frequently than the end of each dividend period) of the continuing appropriateness of these assignments. The amount and types of documentation to support the assignment of securities to the measurement categories will vary from credit union to credit union based on its size and the complexity of its operations, including the nature and scope of its securities activities. A credit union's documentation may include its:

- written and approved securities policies and strategies,
- policies governing liquidity and funds management and interest rate risk management,
- board or committee minutes,
- budgets,
- cash flow projections,
- capital plans, and
- memorandums discussing the purposes or reasons for purchasing particular securities.

In addition, a credit union's history of holding specific types of securities to maturity can be a form of documentation. A credit union's management shall recognize that GAAP envisions that sale and transfer out of the *held-to-maturity* category generally should be rare and that any such transactions may raise questions about the appropriateness of the credit union's designation of other securities as *held-to-maturity*.

6060.1.1 HELD-TO-MATURITY

To qualify as having established intent to hold-to-maturity the credit union cannot have an intent to hold the security only for an indefinite period. If the credit union *may* sell the security due to:

- changes in market interest rates and related changes in prepayment risk,

- needs for liquidity,
- changes in funding sources and terms,
- changes in the availability of and the yield on alternative security, etc.,

the credit union has failed to meet the "hold to maturity" test. A credit union's alternatives are to classify the security as either *available-for-sale* or in a *trading* account.

Through an established and documented asset-liability management strategy, a credit union may decide that it can accomplish the necessary liquidity, funds management, and management of interest rate risk goals without having all of its debt securities *available-for-sale*. GAAP acknowledges that even though a credit union considers the maturity and repricing characteristics of all of its debt securities as part of its asset-liability management, the credit union may determine that it can carry out the ongoing adjustments to its asset-liability position without having all of its debt securities *available-for-sale*. In such a situation, the credit union may earmark specific debt securities as unavailable to be sold for purposes of adjusting its asset-liability position. This would enable the earmarked securities to be placed in the *held-to-maturity* category provided the credit union otherwise has the positive intent and ability to hold them to maturity. For example, if at the point of purchase of a CMO, a credit union can demonstrate that:

1) The failure of the HRST caused by future interest-rate swings is remote; and

2) All probable future liquidity needs can be met through the sale of other securities;

then the classification of the CMO as *held-to-maturity* will be accepted.

A credit union can successfully defend the sale of a *held-to-maturity* security, prior to maturity, under two conditions:

a) The sale is so near the maturity date that the security's value is little affected by changes in market interest rates.

b) The sale occurs after the credit union has already collected a substantial portion (e.g., percent or more) of the principal outstanding at acquisition.

Additionally, a credit union could experience any of the following "changes in circumstances" which may cause a credit union to sell or transfer a *held-to-maturity* security to another classification without raising questions about whether it was appropriate for that security to have been reported previously as *held-to-maturity*:

a) A significant deterioration in the issuer's creditworthiness.

b) A merger, purchase and assumption, or other business combination that necessitates the sale or transfer of *held-to-maturity* securities to maintain the credit union's existing interest-rate risk position or credit risk policy.

c) A change in statutory or regulatory requirements causing the credit union to dispose of a *held-to-maturity* security (e.g., mandated change to risk based capital reserving structure).

d) A significant increase by the regulator in capital requirements that causes the credit union to downsize by selling *held-to-maturity* securities.

Reverse repurchase and repurchase arrangements do not in and of themselves preclude a credit union from placing such securities in the *held-to-maturity* category provided the credit union otherwise has the positive intent and ability to hold the securities to maturity.

6060.1.2 TRADING

Securities are *trading securities*, if they are bought and held principally for the purpose of selling them in the near term. Characteristic of trading is active and frequent buying and selling, and *trading* securities are generally used with the objective of generating profits on short-term differences in price. Unrealized holding gains and losses for *trading* securities shall be included in the income statement. Dividend and interest income, including amortization of premium and discount, shall continue to be included in the income statement.

6060.1.3 AVAILABLE-FOR-SALE

Securities not classified as trading and not meeting the requirements of *held-to-maturity* shall be classified as securities *available-for-sale*. Adjustments shall be made directly to the investment account. Unrealized holding gains and losses shall be excluded from the income statement and reported as a net amount in a separate component of equity on the balance sheet until realized. Dividend and interest income, including amortization of premium and discount, shall continue to be included in the income statement.

6060.1.4 TRANSFERS BETWEEN CATEGORIES

Transfers between categories shall be accounted for at fair value with unrealized holding gains or losses accounted for as shown in the table which follows. Transfers into and out of the *held-to-maturity* category should be rare. Furthermore, a decision to designate a security as *held-to-maturity* may affect a credit union's ability to transfer or sell a security without sacrificing the ability to continue to carry the remainder of its *held-to-maturity* portfolio at amortized cost. As a result, a credit union's initial designation of its securities may adversely affect the degree of flexibility it has to manage its securities portfolio as a secondary source of liquidity. Given the nature of a *trading* account, transfers into or out of the *trading* category should also be rare.

Investment Transferred From/To:	**Transfer at:**	**Unrealized Holding Gain or Loss**
<u>From</u> *Trading* category	Fair Value	Already recognized in earnings and shall not be reversed
<u>To</u> *Trading* category	Fair Value	Recognized in earnings immediately
<u>To</u> *Available-for-sale* category <u>from</u> Held-to-maturity category	Fair Value	Separate component of shareholder's equity
<u>To</u> *Held-to-maturity* category <u>from</u> the *Available-for-sale* category	Fair Value	Continue reporting as a separate compo nent of shareholders' equity but begin amortization over the remaining life of the security as an adjustment of yield in a manner consistent with the amortization of any premium or discount

6060.1.5 IMPAIRMENT OF SECURITIES

If the credit union experiences a decline in either an *available-for-sale* or *held-to-maturity* security's value which is *other than temporary*, the cost basis of the individual security shall be written down to fair value as a new cost basis and the writedown included in the income statement as a realized loss. This is the only adjustment to a security's book value that shall be made through an allowance (asset valuation) account; all other adjustments shall be made directly to the investment account. An other-than-temporary impairment should be considered to have occurred if it is probable that the investor will be unable to collect all amounts due according to the contractual terms of a debt security not impaired at acquisition. The new cost basis shall not be changed for subsequent recoveries in fair value.

6060.2 DEFINITIONS

Certain investment transactions and activities defined below may or may not be permissible for federal credit unions in accordance with Sections 107(7) and 107(8) of the Federal Credit Union and Part 703 of the National Credit Union Administration Rules and Regulations. Additional definitions are also available in the referenced part of the Rules and Regulations.

Adjusted Trading-Any method or transaction used to defer a loss whereby a federal credit union sells a security to a vendor at a price above its current market price and simultaneously purchases or commits to purchase from that vendor another security above its current market price.

These investments are highly complex. In order to understand the transactions and activities the reader must understand the following terminology.

Bailment for Hire Contract-A contract whereby a third party of other financial institution, for a fee, agrees to exercise ordinary care in protecting the securities held in safekeeping for its customers.

Cash Forward Agreement -An agreement to purchase or sell a security, at a future date, with delivery and acceptance being mandatory. The contract for the purchase or sale of a security for which delivery of the security is made in excess of thirty (30) days but not exceeding one hundred-twenty (120) days from the trade date shall be considered to be a cash forward agreement.

Debt security. Any security representing a creditor relationship with an entity. As it applies to federal credit unions, debt securities include such investments as U.S. Treasury securities and Mortgage Backed Securities (MBSs) such as mortgage pass-through securities and Collateralized Mortgage Obligations (CMOs). Debt securities do not include accounts receivable on member loans.

Equity security. Any security representing an ownership interest in an entity or the right to acquire or dispose of such ownership at fixed or determinable prices. An example of an equity security investment is a mutual fund.

Fair value. The current amount at which an investment could be bought, sold, or otherwise exchanged between willing parties, other than in a forced liquidation sale.

Futures Contract - A standardized contract for the future delivery of commodities, including certain government securities, sold on designated commodities exchanges.

Holding gain or loss. The net change in fair value of a security. It does not include earned dividends or interest which have not been received or write-downs resulting from permanent declines in fair value.

Market Price - The last established price at which a security is sold.

Maturity Date - The date on which a security matures. It does not mean the call date or the average life of the security.

Repurchase Transaction - A transaction in which a federal credit union agrees to purchase a security from a vendor and to resell the same or any identical security to the vendor at a later date. A repurchase transaction may be of three types: (a) an “investment-type repurchase transaction”, (b) a “financial institution-type repurchase transaction”, or (c) a “loan-type repurchase transaction.”

a) An “Investment-type Repurchase Transaction” is where the federal credit union purchasing the security takes physical possession of the security, or receives written confirmation of the purchase and a custodial or safekeeping receipt from a third party under a written bailment for hire contract, or is recorded as the owner of the security through the Federal Reserve Book-Entry System; there is not restriction on the transfer of the security purchased by the federal credit union; and the federal credit union is not required to deliver the identical security to the vendor upon resale.

b) A “Financial Institution-type Repurchase Transaction” is a repurchase transaction with an institution identified in Section 107(8) of the Act.

c) “A Loan-type Repurchase Transaction” is any repurchase transaction that does not qualify as an investment-type or financial institution-type repurchase transaction. A lone-type repurchase transaction represents a lending transaction and is subject to the limitations of Section 107(5) of the Act.

Reverse Repurchase Transaction - A transaction whereby a federal credit union agrees to sell a security to a purchaser and to repurchase the same or any identical security from the purchaser at a future date and at a specified price. A reverse repurchase transaction represents a borrowing transaction and is subject to the limitations of Section 107(9) of the Act.

Settlement Date - The date originally agreed to by a federal credit union and a vendor for settlement of the purchase or sale of a security.

Security - Any investment or deposit authorized for a federal credit union pursuant to Sections 107(7), 107(8) and 107(15) of the Act.

Short Sale - The sale of a security not owned by the seller.

Standby Commitment - An agreement to sell a security on or before a future date at a predetermined price. The seller of the agreement is required to accept delivery of the security (in the case of a commitment to buy) or make delivery of a security (in the case of a commitment to sell) in either case at the option of the buyer of the commitment.

Trade Date - The date the federal credit union originally agreed, whether verbally or in writing, to enter the purchase or sale of a security with a vendor.

Investment types and terms are further defined in Part 703, NCUA Rules and Regulations.

6060.3 AUTHORIZED INVESTMENT ACTIVITIES

Part 703, NCUA Rules and Regulations, identifies securities that federal credit unions may invest in. These securities are authorized by Section 107(7) and 107(8) of the Federal Credit Union Act. Federal credit unions should refer to these sources prior to making investment decisions.

Not all the permissible investments for credit unions are covered in the following sections. A few examples of permissible investments and the recommended accounting treatment are shown.

6060.3.1 CASH-INVESTMENT PURCHASE

A credit union may enter into a contract to purchase (or sell) a security authorized in Section 107 of the Act provided that the security is delivered within 30 days of the trade date. The purchase of a security should be recorded on the credit union’s records at cost which is the market price on the trade date.

6060.3.2 CASH FORWARD AGREEMENTS

A federal credit union may enter into a cash forward agreement to purchase or sell a security, provided that:

a) The period from the trade date to the settlement date does not exceed 120 days;

b) It has written cash flow projections evidencing its ability to purchase the security (purchaser);

c) It owns the security on the trade date (seller); and

d) The cash forward agreement is settled on a cash basis at the settlement date.

Prior to settlement, the amount of the cash forward agreement represents a contingent liability to purchase securities. Therefore, it needs to be shown as a note or memorandum entry on the credit union's Statement of Financial Condition for each month the commitment is outstanding. The note should describe the agreement, trade and settlement date, amount, purchase and market price on the statement date.

Illustrative Entries

Assume that JWP FCU entered into a Cash Forward Agreement to purchase a $1 million part value Federal Agency Security on March 16 at 95, which is the market price for a 90-day forward. The FCU had written projections which showed that it had a $1 million certificate of deposit maturing on June 15, the settlement date of the forward. The market value of the security was 93 on June 14.

March 16

The commitment is recorded in the cash forward agreement register. Future financial statements of the federal credit union are footnoted.

June 15

Dr.-Available-for-Sale Securities (Acct. No. 743)	$930,000	
Dr.-Gain (Loss) on Investments (Acct. No. 420)	20,000	
Cr.-Cash (Acct. No. 731)		$950,000

The original footnote denoting market value would be removed from the financial statements.

6060.3.3 CASH FORWARD AGREEMENT TO SELL SECURITIES

A federal credit union may enter into a cash forward agreement to sell a security, provided that:

a) The period from the trade date to the settlement date does not exceed 120 days;

b) It owns the security on the trade date;

c) The cash forward agreement is settled on a cash basis at the settlement date.

A federal credit union must be able to provide information on the type of security sold by use of a cash forward agreement to include a complete description, trade date, settlement date, sale price and name of the purchaser. Such information should be kept in a current register for that purpose.

Prior to settlement, the amount of the cash forward agreement represents a contingent liability to deliver securities. Therefore, it needs to be shown as a note or memorandum entry on the credit union's Statement of Financial Condition for each month the commitment is outstanding. The gain or loss on the sale of the underlying security should not be recognized until the settlement date and will be recorded in Gain (Loss) on Investments (Account No. 420).

Illustrative Entries

Assume that MAY FCU owns a Federal Agency Security recorded on its books for $950,000. It commits on June 10 to sell the security on August 20 for $975,000.

June 10

The commitment is recorded in the cash forward agreement register. Future financial statements are noted.

August 20 - To record the sale of the security and recognize the gain on the sale. Note is removed from the financial statements.

Dr.-Cash (Acct. No. 731)	$975,000	
Cr.-Available-for-Sale Securities (Acct. No. 743)		$950,000
Cr.-Gain (Loss) on Investments (Acct. No. 420)		25,000

6060.3.4 INVESTMENT-TYPE REPURCHASE TRANSACTIONS

The purpose of an investment-type repurchase transaction is to obtain a specified yield on the investment made. A federal credit union may enter into this type of transaction provided the transaction is as defined in Section 6060.2. Any repurchase transaction that does not meet these requirements constitutes a loan-type repurchase transaction. The purchase price of a security obtained under an investment-type repurchase transaction must be at or below the market price.

A federal credit union must maintain certain information on the type of security purchased through an investment-type repurchase transaction in a Repurchase Investment Register. This register must include an identification of the security (type, face value, coupon rate), trade date, settlement date, amount, repurchase rate, purchase price and the name of the seller.

Each investment-type repurchase transaction must be documented by the following:

a) evidence that the credit union has been recorded as the owner of the security through the Federal Reserve book-entry system,

b) for those securities in the physical possession of the credit union, there must be clear evidence of ownership of the security,

c) for those securities held in safekeeping, there must be a copy of the “bailment for hire contract” from the third party bank or other financial institution, and a safekeeping receipt.

The security purchased should be recorded at cost in the appropriate investment account. The credit union’s Statement of Financial Condition must be noted to reflect the amount of securities which are subject to resale and the date of resale. Income earned on the investment should be recorded in the appropriate income account.

Illustrative Entries

Assume that RFS FCU entered into an investment-type repurchase transaction on September 30 to purchase a mortgage-backed federal agency security with a face value of $2,142,857 and a coupon rate of 8.50. The parties agreed upon a repurchase rate of 9.0. The purchase price was 98. Also assume that the FCU agreed to resell a similar type security to the vendor on October 1 at 98.

September 30-To record the purchase of the security:

The funds are transferred to the broker through the credit union’s custodial bank, which transmits a custodial slip to the FCU. The transaction is recorded in the repurchase transaction register. The financial statements of the federal credit union are noted.

Dr.-Available-for-Sale Securities (Acct. No. 743) ($2,142,857 x 98)	$2,100,000	
Cr.-Cash (Acct. No. 731)		$2,100,000

October 1 - To record resale of the security and receipt of income.

Dr.-Cash (Acct. No. 731)	$2,100,525*	
Cr.-Available-for-Sale Securities (Acct. No. 743)		$2,100,000
Cr.-Income from Investments (Acct. No. 122)		525

* - ($2,142,857 x .980245)

The original note would be removed from the financial statements.

6060.3.5 FINANCIAL INSTITUTION-TYPE REPURCHASE TRANSACTION

A federal credit union may enter into a financial institution-type repurchase transaction with an institution identified in Section 107(8) of the Act. The purpose of such a transaction is to obtain a specified yield on the investment made. The purchase price of the security obtained under a financial institution-type repurchase transaction must be at or below the market price.

A federal credit union must be able to provide information on the security purchased to include an identification of the security (type, face value, coupon rate), trade date, settlement date, amount, repurchase rate, purchase price and the name of the seller. Such information should be kept in a current register for that purpose.

A federal credit union must also be able to clearly document that it is the owner of the security and that the security is adequately safekept. The security purchased should be recorded at cost in the appropriate investment account. The credit union's Statement of Financial Condition should be noted to reflect the amount of securities which are subject to resale and the date of resale. Income earned on the investment should be recorded in the appropriate income account.

6060.3.6 LOAN-TYPE REPURCHASE TRANSACTION

A federal credit union may enter into a loan type repurchase transaction only with its own members, other credit unions, or approved credit union organizations. Loan-type repurchase transactions are subject to specific requirements such as a maximum loan limit of 10 per centum of paid-in and unimpaired capital and surplus to one member, the receipt of a properly supported loan application, approval of the loan by the credit committee, and execution of a note supported by documentation of the collateral. Loans Subject to Repurchase Agreements (Account No. 718) should be used to record these loans to members.

Loan-type repurchase agreements to other credit unions must conform to limitations contained in Sections 107(5)(C) and 107(7)(C) of the Act and Section 703.2 of the National Credit Union Administration Rules and Regulations. Loan-type repurchase agreements should be recorded in "Loans to Other Credit Unions," (Account No. 747).

Loan-type repurchase agreements to approved credit union organizations must be in compliance with Section 107(5)(D) of the Act and the National Credit Union Administration Rules and Regulations. "Loans to Credit Union Service Corporations," (Account No. 748.2) should be used to record these loans.

Where material in amount, the securities used as collateral for the loan-type repurchase agreement should be identified in a note or memorandum entry on the credit union's Statement of Financial Condition for each month the repurchase agreement is outstanding. The note should reflect the market price of the securities on the statement date.

Income received from loans to members should be recorded in "Interest on Loans," (Account No. 111). Income received from loans to credit unions should be recorded in "Income from Investments," (Account No. 127) and (Account No. 128).

Assume HEM FCU enters into a repurchase agreement with VAF FCU whereby HEM FCU lends $1 million to VAF FCU on February 1 and receives as collateral a $1 million Federal Agency Security valued at par. VAF FCU agrees to repay the loan on August 1. The interest rate is 6 percent.

February l-Entry on the books of HEM FCU to record the loan.

Dr.-Loans to Other Credit Unions (Acct. No. 747)	$1,000,000	
Cr.-Cash (Acct. No. 731)		$1,000,000

The financial statements of the federal credit union should be noted.

August 1-HEM FCU entry to record repayment of the loan with interest.

Dr.-Cash (Acct. No. 731)	$1,030,000	
Cr.-Loans to Other Credit Unions (Acct. No. 747)		$1,000,000
Cr.-Income from Investment (Acct. No. 127)		$30,000

The original note should be removed from financial statements.

Entries for VAF FCU are contained in Illustrative Accounting Entries in the following section.

6060.3.7 REVERSE REPURCHASE TRANSACTION

A federal credit union may enter into a reverse repurchase transaction, provided no securities purchased with the funds received from the reverse repo, nor any securities collateralizing the reverse repo, have a maturity date later than the settlement date for the reverse repo.

The maximum amount of funds that may be borrowed under a reverse repurchase transaction for investment or deposit purposes is 50 percent of the credit union's paid-in and unimpaired capital.

Since reverse repos represent a borrowing activity, such activity must be approved by the board of directors or a duly appointed executive committee as required by Section 113 of the Federal Credit Union Act. The funds received from the reverse repos should be recorded as borrowed funds in "Notes Payable-Other," (Account No. 812). Interest paid on reverse repos should be recorded in "Interest on Borrowed Money," (Account No. 340).

The securities used as collateral for the reverse repos should be identified in a note on the credit union's Statement of Financial Condition for each month the reverse repo is outstanding. The note should reflect both the book value and the market price on the statement date.

Referring to the various illustrative accounting entry, VAF FCU would record the Reverse Repurchase Transaction. In addition to the information given in that example, assume also that VAF FCU is unable to repay the loan from available funds on settlement date. VAF FCU chooses to sell the underlying security at its fair market value of 99-1/2. The security is booked at par.

Entries on books of VAF FCU.

February 1-To record the Reverse Repo as borrowed funds.

Dr.-Cash (Acct. No. 731) $1,000,000
Cr.-Notes Payable-Other
(Acct. No. 812) $1,000,000

The financial statements of the federal credit union should be noted.

August 1-To record sale of the underlying security recognizing a $5,000 loss.

Dr.-Cash (Acct. No. 731) $995,000
Dr.-Gain (Loss) on
Investments (Acct. No. 420) 5,000
Cr.-Available-for-Sale
Securities (Acct. No. 743) $1,000,000

To record payment of notes payable and interest due.

Dr.-Notes Payable
(Acct. No. 812) $1,000,000
Dr.-Interest on Borrowed
Money (Acct. No. 340) 30,000
Cr.-Cash (Acct. No. 731) $1,030,000

The original note should be removed from the Statement of Financial Condition.

6060.4 UNAUTHORIZED INVESTMENT TRANSACTIONS AND ACTIVITIES

Because of the inherent risk involved in certain investment transactions and activities a federal credit union may not:

1) enter into a standby commitment to purchase or sell a security,

2) buy or sell a futures contract,

3) engage in adjusted trading or a short sale,

4) enter into a yield maintenance contract, or

5) participate in a pair-off transaction.

6060.4.1 ADJUSTED TRADING

The most common form of adjusted trading occurs when a credit union cannot meet its commitment to purchase a security on the settlement date, and the market price is below the commitment price. Thus, if the credit union is forced to immediately sell the security it will incur a loss.

To prevent the loss, the credit. union would enter into an agreement to resell the security to the broker at the commitment price and to enter into another commitment to purchase a different security at a price that exceeds its market value. Thus, the credit union has deferred its loss in hopes that the market price of the security underlying the new commitment will increase by the new settlement date.

A less common form of adjusted trading occurs when a credit union swaps or exchanges a lower yielding security for a higher yielding security. In this case, the sale of the low yielding security would result in a loss, which the credit union does not wish to recognize during the current accounting period. Again, the credit union agrees to sell its security and buy the new security at prices above market. Another name for these transactions is overtrading.

A variation of the adjusted trade involving a forward commitment is known as “fee trading” or “reposition trading.” This transaction is the s as the first example above except that the broker is unwilling to take the risk of purchasing the initial security. The credit union would sell at a price above market. Therefore, the broker requires that the credit union pay a fee, which is the difference in the commitment price and the market price when they enter into the transactions. When the credit union purchases the new security, the broker returns the fee. Often, this type of transaction occurs repeatedly. The fee is usually recorded by the credit union as a receivable, deferred charge, or other asset.

The above described transactions, under whatever name, constitute adjusted trading and, thus, are prohibited

6060.4.2 YIELD MAINTENANCE CONTRACT

A yield maintenance contract, also known as a “pair-off” hedger, is the concurrent commitment to purchase a security via a cash forward agreement and to sell the same security on the same settlement date via a standby commitment. The credit union would be required to pay a generally exorbitant commitment fee to the vendor. The purpose of the transaction would be to “guarantee” a specified yield which is based upon the commitment fee paid. Generally, the purchase and sale prices are not related to the current market price.

Yield maintenance contracts are not permitted since they violate Section 708.4 of the National Credit Union Administration Rules and Regulations. This section prohibits a federal credit union from’ entering into a standby commitment. The yield maintenance contract is an unsecured loan to a broker (a nonmember) and thus is in violation of Section 107(5) of the Federal Credit Union Act.

6060.4.3 PAIR-OFF TRANSACTION

A pair-off is a security purchase transaction which is closed or sold at, or prior to, the settlement date.

Generally, a federal credit union could commit to purchase a security and sometime thereafter commit to seller the security on the same settlement date. The purpose in engaging in pair-off transactions is not to take delivery of the security purchased, but to speculate that the market price will increase before settlement date and a gain will result from its sale.

Many times the commitment to sell is made the same day as the commitment to purchase. There may even be a standing order with the vendor to sell when a certain market price is reached. *Pair-off transactions using cash forward agreements are impermissible for federal credit unions.* In addition, pairoff transactions represent a speculative activity which are generally unsafe and unsound. There is strong evidence to show that it has been used as a means of “churning” credit union accounts to generate brokerage commissions.

6060.5 PERMISSIBLE INVESTMENT ACTIVITIES AND TRANSACTIONS SUBJECT TO SPECIFIED CONDITIONS

6060.5.1 DOLLAR PRICE REPURCHASE AGREEMENT (DOLLAR PRICE REPO)

A dollar price repurchase transaction is a contract whereby a federal credit union sells a security that it owns and agrees to purchase another security on a future date. The dollar price repo does not represent borrowing by a federal credit union as does a reverse repurchase transaction.

In the case of a reverse repurchase transaction, the transaction represents a borrowing because ownership of the security “sold” does not change; that is, the “seller” of the security still has title and still receives the dividend or interest income from the security. Interest based upon the balance of the proceeds received from the transaction is paid by the “seller.” Additionally, the same security “sold” must be “repurchased.” As such the essentials of a sale and repurchase do not exist.

In the case of a dollar price repo, the essential elements of a sale do exist, i.e., ownership of the security does change. The buyer now receives the dividend or interest income on the security. No interest is paid by the seller for funds received. The same security sold is not required to be repurchased.

A dollar price repo represents the sale of a security and a simultaneous agreement to purchase another security at a future date by the use of a forward placement contract. As such, a federal credit union may enter into such an agreement only if:

a) Gains and losses on the sale of the security sold are recognized on the settlement date of the sale.

b) The limitations cited in Section 703.3(b) of the NCUA Rules and Regulations for purchasing a security under a cash forward agreement are met.

6060.6 MORTGAGE-BACKED SECURITIES

6060.6.1 MORTGAGE PASS-THROUGH SECURITIES

Mortgage pass-through securities were the first form of mortgage collateralized securities to be issued and are the predominant form of mortgage-backed security actively traded among investors today. With a pass-through security, investors purchase an undivided interest in an underlying pool of mortgages that serves to collateralize the pass-through security. As the mortgages in the pool are repaid, principal and interest are passed through to each investor on a pro rata basis. All pass-through securities have an issue date; a coupon or pass-through rate; and a final or stated maturity date.

Mortgage originators, such as commercial banks, S & Ls & Ls, etc., are among the most active in pooling mortgages and issuing pass-through securities. The originator usually issues a pass-through with the guarantee of a federally sponsored agency. In addition, a large volume of mortgages are purchased, pooled and collateralized under agency programs. The agencies that guarantee and issue pass-through securities are the Government National Mortgage Association (Ginnie Mae); the Federal Home Loan Mortgage Corporation (Freddie Mac); and the Federal National Mortgage Association (Fannie Mae).

When a pass-through is not backed by the guarantee of a federally sponsored agency, it falls into the category of “privately issued” and may be backed by pool insurance, letters of credit, and other credit enhancements.

Federal credit unions may invest in pass-through securities issued or guaranteed by the Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), or the Federal Home Loan Mortgage Corporation (Freddie Mac). Under Section 107(15)(B) of the Federal Credit Union Act, federal credit unions may also invest in privately issued pass-through securities as defined in Section 3(a)(41) of the Securities Exchange Act of 1934.

When a credit union acquires a mortgage pass-through security, it must assess its intent and ability with regard to the security and assign it to the appropriate measurement category: *trading, held-to-maturity*, or *available-for-sale*. Not less frequently than the end of each dividend period, (i.e., monthly, quarterly, semiannually or annually), the appropriateness of the classifications, and the reasonableness and accuracy of the related measurement (*trading* and *available-for-sale*), shall be assessed. See Section 6060.1 for more complete discussion.

Illustrative Entries

The IMU FCU purchased $100,000 worth of passthrough securities for $99,000. The securities have a 30 year life and have a 10% pass-through paid monthly. The annual effective yield to maturity is 10.12%. The credit union has the ability to hold the investment to maturity and the positive intent to hold it for the foreseeable future. *(Note.*- This illustration assumes no significant changes in prepayment assumption from the purchase date to maturity, therefore, periodic adjustments to the investment carrying value are not illustrated.)

a) IMU's entry at the point of purchase.

Dr.-Held-to-Maturity Securities
(Acct. No. 741) $100,000
Cr.-Discount on Held-to-
Maturity Securities
(Acct. No. 741.1) $1,000
Cr.-Cash (Acct. No. 731) 99,000

b) To record the receipt of the first monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference between income at the pass-through rate and income at the effective rate), and the return of principal.

Dr.-Cash (Acct. No. 731) $877.75
Dr.-Discount on Held-to-
Maturity Securities (Acct. No. 741.1) 1.57
Cr.-Income on Federal
Agency Securities (Acct. No. 122) $834.90
Cr.-Held-to-Maturity
Securities (Acct. No. 741) 44.24

c) To record the receipt of the second monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference between income at the pass-through rate and income at the effective rate), and the return of principal.

Dr.-Cash (Acct. No. 731) $877.57
Dr.-Discount on Held-to-
Maturity Securities (Acct. No. 741.1) 1.56
Cr.-Income on Federal
Agency Securities (Acct. No. 122) $834.52
Cr.-Held-to-Maturity Securities
(Acct. No. 741) 44.61

If the credit union holds this investment to maturity, they should receive a full return of principal plus interest.

If there is a significant change in prepayment assumptions on the underlying pool of mortgages, i.e., the underlying mortgages are paying significantly faster or slower than anticipated, the carrying value must be adjusted to reflect the change in prepayment rate.

This adjustment is accomplished by discounting the cash flows received to date, plus the cash flows the credit union anticipates to receive in the future based on the new prepayment assumptions back to the original purchase date to determine the new anticipated yield. The new yield thus calculated is then applied from date of purchase to calculate what the carrying value of the security would be today had the new yield been applied since purchase.

The booked carrying value is then adjusted through current period income to reflect the adjusted carrying value and the amortization is continued at the new effective rate.

6060.6.2 COLLATERALIZED MORTGAGE OBLIGATIONS (CMOs)

A CMO is a multi-class bond issue collateralized by whole mortgage loans or mortgage passthrough securities. The cash flows of the underlying mortgages are used to make the principal and interest payments on the bonds.

The key difference between a conventional mortgage pass-through security, such as a Government National Mortgage Association (Ginnie Mae) pass-through, and a CMO is in the distribution of principal payments. With a conventional pass-through, the interest and principal payments received each month from mortgage holders are passed through to all security holders on a pro rata basis. Because of prepayments, the pass-through's cash flows tend to be irregular and widely dispersed over time. The security remains outstanding for as long as any of the mortgages in the underlying mortgage pool are outstanding (up to 30 years where the pass-through is backed by long-term mortgages).

The CMO structure substitutes sequential retirement of bonds for the pro rata return of principal found in the pass-through, the result of which is to create mortgage-backed securities with short, intermediate and long-term maturities.

Typically, the first class of CMO bonds receives all principal generated by the issue until it is completely retired; then the second class begins to receive principal until it is retired and so on. Interest is paid on all outstanding bonds unless they are accrual or "Z" bonds.

The typical CMO has been characterized by four classes (or tranches) with the fourth class often being a "Z" bond. The second and third classes receive level interest payments in accordance with their stated coupon rates, while the first class pays down. Then the third class continues to receive level interest payments until the second class is paid down and so forth. The fourth class, the "Z" bond, accrues its stated interest rate as an addition to its initial face value until all of the previous classes have been retried.

Once all of the previous classes have been retried, the "Z" bond becomes a pass-through instrument. Principal and interest, based on the accrued principal amount, is then paid to the holders until the "Z" bond is completely paid down, at which point the CMO is closed.

CMO's have been issued by the Federal Home Loan Mortgage Corporation (Freddie Mac) and the Federal National Mortgage Association (Fannie Mae) and have also been privately issued by securities firms, S&L's, mortgage bankers, home builders, and life insurance companies. A federal credit union may invest in CMO's issued by Freddie Mac or Fannie Mae and privately-issued CMO's as defined by Section 3(a)(41) of the Securities Exchange Act of 1934.

HRST in Relation to Available-for-sale. GAAP interpreted in light of NCUA Rules and Regulations part 703 may have the practical effect of requiring credit unions to classify most collateralized mortgage obligations (CMOs) as "*available-for-sale*" necessitating marking to fair value. The part 703 "high risk security test", (HRST) which may precipitate divestiture of a CMO, may be viewed as hindering a credit union's ability to successfully assert they have both the "*intent and ability to hold-to-maturity*" which is necessary under GAAP to defend a *hold-to-maturity* classification. The *hold-to-maturity* classification permits measurement at amortized cost. Lacking the ability to *hold-to-maturity*, and in the absence of *Trading* intent, the CMO must be classified as "*available-for-sale*".

At one point, FASB had taken the position that the application of divestiture policies may not remove the uncertainty about whether, from an auditor's standpoint, a credit union's regulators might in future years seek the divestiture of a mortgage derivative security that is currently or later becomes "high-risk". Thus, auditors *may conclude* that the more detailed explanation of divestiture is not sufficiently workable for them to accept a credit union's designation of "non high-risk mortgage securities" as *held-to-maturity* securities for reporting purposes. Those credit unions not seeking a CPA's opinion on their financial statements will have to support a CMO classification other than *available-for-sale* or *trading* by establishing a defensible and persuasive case that they have the intent and ability to hold-to-maturity consistent with the requirements of GAAP.

Regulations require that a federal credit union shall not have high-risk securities in its portfolio, unless they are being used solely to offset interest-rate risk and, for that reason, divestiture may become necessary. The regulatory language explains that ". . .NCUA will address divestiture situations on a *case-by-case basis*. . . existing policies and procedures permit NCUA and the affected credit union to develop a liquidation plan appropriate to the *circumstances of the case*. The plan would take into account all relevant factors, including the dollar amount of the security, the remaining time to maturity, and the likelihood that the security may again pass the high-risk security test at a future testing date. . ." Safety and soundness risks can arise from the size of a credit union's holding of high-risk mortgage securities in relation to its capital and earnings, management's inability to demonstrate an understanding of the nature of the risks inherent in the securities, the absence of internal monitoring systems and other internal controls to appropriately measure the market and cash flow risk of these securities, or management's inability to prudently manage its overall interest rate risk or similar factors.

NCUA will continue to study its security regulations and supervisory policy statements governing credit union securities to grant credit unions the full discretion they need to best manage their resources within safe and sound boundaries. The automatic transfer of a CMO classified as *held-to-maturity* to *available-for-sale* upon failing the HRST may not be required. For example, in rare cases where the "divestiture plan" approved lay NCUA permits the holding of the CMO until maturity, the automatic transfer to *available-for-sale* is not necessary. The provisions of GAAP will govern the classification and accounting treatment of security portfolios. The designations of securities under GAAP and the required documentation shall be among the matters reviewed as part of any external audit of a credit union.

Illustrative Entries

Suppose a credit union invested $92,128.55 in the second tranche of a CMO valued at $100,000. The credit union has the ability to hold the investment to maturity and the intent to hold it for the foreseeable future. The estimated life of the second tranche of the CMO is 6 years with receipt of interest only for 3 years while the first tranche receives principal and interest payments and receipt of principal and interest payments for the next three years. The pass-through rate of interest is stated as 7% and the annual effective yield to maturity is expected to be 9.1936%. (*Note*: This illustration assumes no significant changes in prepayment assumption from the purchase date to maturity, therefore, periodic adjustments to the investment carrying value are not illustrated.)

a) The credit union's entry at the point of purchase.

Dr.-Held-to-Maturity Securities (Acct. No. 741)	$100,000.00	
Cr.-Discount on Held-to-Maturity Securities (Acct. No. 741.1)		$7,871.45
Cr.-Cash (Acct. No. 731)		92,128.55

b) To record the receipt of the first monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference between income at the pass-through rate and income at the effective rate) and the receipt of income at the pass-through rate while the first tranche is receiving a payment of principal plus interest.

Dr.-Cash (Acct. No. 731)	$583.33	
Dr.-Discount on Held-to-Maturity Securities (Acct. No. 741.1)	122.50	
Cr.-Income on Federal Agency Securities (Acct. No. 122)		$705.83

c) To record the receipt of the second monthly payment: the recognition of income at the effective rate, the accretion of discount (the difference between income at the pass-through rate and income at the effective rate) and the receipt of income at the pass-through rate while the first tranche is receiving a payment of principal plus interest.

Dr.-Cash (Acct. No. 731)	$583.33	
Dr.-Discount on Held-to-Maturity Securities (Acct. No. 741.1)	123.43	
Cr.-Income on Federal Agency Securities (Acct. No. 122)		$706.76

At the end of three years when the first tranche is fully satisfied, the second tranche will become a pass-through security and the accretion of discount using the interest method will proceed as demonstrated in the previous section to pass-through securities. Remember, when there is a significant change in prepayment assumptions (rates) the carrying value of the security must be adjusted through current period income.

6060.6.3 STRIPPED MORTGAGE-BACKED SECURITIES (IO's/PO's)

Stripped Mortgage-Backed Securities (SMBS's) consist of two classes of securities with each class receiving a different portion of the monthly interest and principal cash flow of the underlying mortgage backed securities. In its purest form, an SMBS is converted into an interest-only (IO) strip, where the investor receives 100% of the interest cash flow and a principal-only (PO) where the investor receives 100% of the principal cash flow.

All IO's and PO's have highly volatile price characteristics based on changes in the prepayment pattern of the underlying mortgages and consequently on the maturity of the stripped security. Generally, IO's will increase in value when interest rates rise. Accordingly, the purchase of an IO strip may serve to offset the interest rate risk associated with mortgages and similar instruments held by a federal credit union.

Similarly, a PO may be useful as an offset to the effect of interest rate movements on the value of mortgage servicing. However, when purchasing an IO or PO, the investor is speculating on the movements of future interest rates and how these movements will effect the prepayment pattern of the underlying mortgage collateral. Further, those SMBS's that do not have the guarantee of a federally sponsored agency (privately-issued SMBS'S) as to the payment of mortgage principal and interest have an added element of credit risk.

NCUA has determined that SMBS's are not suitable investments for the vast majority of federal credit unions. SMBS'S, however, may be appropriate holdings for federal credit unions that have highly sophisticated and well-managed securities portfolios or mortgage portfolios. In these federal credit unions, however, the acquisition of SMBS's should be made only in compliance with carefully developed and documented plans prescribing specific positioning limits and control arrangements for enforcing those limits. These plans must be approved by the federal credit union's board of directors and vigorously enforced.

SMBS's have been issued by the Federal National Mortgage Association (Fannie Mae) and have also been "privately-issued" to a limited degree. A federal credit union may purchase SMBS's issued by Fannie Mae and may also purchase "privately-issued" SMBS's as defined in Section 3(a)(41) of the Securities Exchange Act of 1934.

Illustrative Entries

Assume a credit union purchased an interest-only investment at a purchase price of 45% expecting 12% yield to maturity. (Note: Interest-only investments are purchased at a percentage of notional value. "Notional value" is the amount of principal upon which interest will be calculated. For purposes of our example, assume a $100,000 notional value.) The credit union has the ability to hold the IO strip to maturity and the positive intent to hold it for the foreseeable future. The credit union will receive scheduled monthly cash distributions as partially detailed in the following entries.

a) Entry at purchase.

Dr.-Held-to-Maturity Securities (Acct. No. 741) $45,000
Cr.-Cash (Acct. No. 731) $45,000

b) Upon receiving the first cash distribution:

Dr.-Cash (Acct. No. 731)	$958.33	
Cr.-Held-to-Maturity Securities (Acct. No. 741)		$508.33
Cr.-Income on Federal Agency Securities (Acct. No. 122)		450.00

6060.7 ZERO COUPON SECURITIES

A zero coupon security is a security that makes no periodic interest payments, but instead is sold at a deep discount to its face (par) value. The buyer of such a security realizes the rate of return by the gradual appreciation of the security, receiving the face value of the security as a lump sum payment on a specified maturity date.

Because zero coupon securities bear no interest, they are among the most volatile of all fixed income securities. Since holders of zero coupon securities do not receive interest payments, these securities fall more dramatically than bonds paying interest on a current basis when interest rates rise.

On the other hand, when interest rates fall, zero coupon securities rise more rapidly in value because the bonds have locked in a particular rate of reinvestment that becomes more and more attractive as rates fall further. The greater the number of years a zero coupon bond has until maturity, the less the investor has to pay for it and the more leverage the investor has at work for him.

For instance, a bond that matures in 5 years may double in value while a bond that matures in 25 years may increase in value 10 times, depending on the interest rate of the bond.

There are various kinds of permissible zero coupon ties for federal credit unions. These include STRIPS which were created to fill a growing demand for zero coupon Treasury securities. STRIPS is an acronym that reflects investor jargon for the practice of “stripping” the coupon from a bond (corpus) and selling the corpus and interest payments separately.

With STRIPS, any depository institution buying Treasury securities can request that each semiannual interest payment and principal be registered as a separate security by the Federal Reserve Bank. Because purchasers of these securities receive no periodic interest payments, STRIPS are considered zero coupon securities.

Assume a credit union purchased a $1,500,000 zero coupon bond for $534,000 expecting an effective yield of 10.6% to maturity in 10 years. Assume also that the credit union has the intent and ability to hold the zero to maturity.

a) The credit union's entry at the point of purchase.

Dr.-Held-to-Maturity Securities (Acct. No. 741)	$1,500,000	
Cr.-Discount on Held-to-Maturity Securities (Acct. No. 741.1)		$966,000
Cr.-Cash (Acct. No. 731)		534,000

b) To record the receipt of the first semiannual accretion of discount:

Dr.-Discount on Held-to-Maturity Securities (Acct. No. 741.1)	$28,302	
Cr.-Income on Federal Agency Securities (Acct. No. 122)		$28,302

c) To record the receipt of the second semiannual accretion of discount:

Dr.-Discount on Held-to-Maturity Securities (Acct. No. 742.2)	$29,802	
Cr.-Income on Federal Agency Securities (Acct. No. 122)		$29,802

Notice that after the first year, the carrying value of the zero coupon bond has grown from $534,000 to $592,104.

6060.8.1 ACCOUNTING FOR MUTUAL FUNDS AND UNIT INVESTMENT TRUSTS

6060.8.1.1 ACCOUNTING FOR MUTUAL FUNDS

When a credit union invests in a mutual fund, it purchases a number of shares (units) in the fund generally paying a broker's commission or load fee as part of the purchase price. The fund invests the proceeds from the sale of shares in a portfolio of securities to be held and /or traded for profit.

The broker's fee or commission is passed on to the broker securing the sale. Each mutual fund investors' share/unit in the mutual fund is worth an amount calculated based on the total market value of the number of outstanding units in the fund. This value per share is known as the net asset value per share. (NAV).

The NAV of a share/unit in the fund fluctuates periodically based on the changing market value of the underlying ties in the mutual fund portfolio, as well as the natural change in the value of the portfolio, inherent in continually buying and selling securities.

Generally, as interest rates fall, the value of the underlying securities in the mutual fund portfolio rises and, likewise, the NAV per share increases; conversely as interest rates rise, the value of the underlying securities in the mutual fund portfolio decreases and, likewise, the NAV per share drops. Thus, the credit union investor's NAV per share drops. The credit union's NAV per share is dynamic, rising and falling with interest rates and the changing securities market.

Generally accepted accounting principles (GAAP) provide that certain equity securities should be accounted for as trading or available for sale at fair value. Fair value for trading accounts is booked through income; fair value for available for sale securities is debited/credited through a separate component of equity in the statement of financial condition.

Illustrative Entry:

Assume a credit union purchased shares/units in three different mutual funds as follows:

1/13/91 Fund A - 10,000 shares @ $10.00 per share
2/05/91 Fund B - 10,000 shares @ $8.00 per share
3/20/91 Fund C - 4,000 shares @ $16.00 per share

The accounting entries made on the credit union's books at the time of purchase are detailed below. The broker's commission (loan fee) is included in the quoted share/unit purchase price.

Dr.-Available-for-Sale Securities (Acct. No. 743)	$245,000	
Cr.-Cash (Acct. No. 731)		$245,000

To continue the example, at the quarter ending 3/31/91 when the credit union is closing its books but prior to paying dividends to its members, the credit union needs to adjust the mutual fund investments to the LCM. Assume that the 3/31/91 market values of the three funds are as shown in the table below:

Mutual Fund	Original Cost	Current Market Value	Gain or (Loss)
A	$100,000	$ 95,000	($5,000)
B	80,000	80,000	
C	65,000	62,000	(3,000)
	$245,000	$237,000	($8,000)
	(A)	(B)	(B-A)

Although, the funds were purchased during the quarter for a total of $245,000, the fair value of the funds in aggregate at 3/31/91 has declined to $237,000. Therefore, the credit union should adjust the carrying value of its mutual fund investments downward to the current fair value.

Dr.-Accumulated Unrealized
Gains/Losses on Available-for-
Sale Securities (Acct. No. 945) $8,000
Cr.-Available-for-Sale Securities
(Acct. No. 743) $8,000

(Account 945 must be netted with Account 940, Undivided Earnings, before the credit union declares dividends.)

Assume during the second quarter, the mutual funds in aggregate increase in value. Assume that at the end of the second quarter, 6/30/91, when the credit union closes their books and before paying dividends, the mutual funds are valued as follows:

Mutual Fund	Original Cost	Current Balance Sheet Value	Current Market Value	Gain or (Loss)
A	$100,000	$ 95,000	$104,000	
B	80,000	80,000	82,000	
C	65,000	62,000	62,000	
	$245,000	$237,000	$248,000	$11,000
		(A)	(B)	(B-A)

In this case the entry would be:

Dr.-Available-for-Sale Securities
(Acct. No. 743) $11,000
Cr.-Accumulated Unrealized
Gains/Losses on Available-for-Sale
Securities (Acct. No. 945) $11,000

6060.8.2 ACCOUNTING FOR UNIT INVESTMENT TRUSTS

A unit investment trust is an investment vehicle that purchases a fixed portfolio of income-producing securities, such as Treasury bonds or mortgage backed securities. Units of the trust, which usually cost at least $1,000.00, are sold to investors by broker/dealers for a sales charge which may range up to 5% of the total dollar amount of the purchase.

With a unit investment trust, investors own an undivided interest in the principal and interest portions of the portfolio in proportion to the amount of money they invest. Usually, the portfolio of securities remains fixed until all the securities mature and unit holders have recovered their principal. Most broker/dealers maintain a secondary market in the units they sell, so that the units can be resold if necessary.

Unlike mutual funds, the underlying portfolio remains fixed until all of the securities have matured. However, similar to mutual funds, a credit union cannot control the securities placed into the trust by the underwriter or the disposal of individual portfolio issues. Accordingly, NCUA has adopted the regulatory accounting practice of requiring credit unions to record unit investment trusts in the same manner as mutual funds, i.e., at fair value through equity.

6060.9 PUT OPTIONS

Increased real estate lending by federal credit unions has led to increased risks related to the interest rate sensitivity of such loans and their longer terms. Under Part 701.21(i) of the NCUA Rules and Regulations, a federal credit union may purchase put options on Government National Mortgage Association (GNMA), Federal National Mortgage Association (FNMA), and Federal Home Loan Mortgage Corporation (FHLMC) securities in order to manage interest rate risk for real estate loans produced for sale on the secondary mortgage market.

When purchasing a put option, a federal credit union acquires the right to sell a certain security at a specified price within a particular period of time. There are two parties to the put option agreement:

a) The “holder” (the credit Union) who, in exchange for paying an up front fee, acquires the right to sell the security in accordance with the option contract.

b) The “writer” (another party) who, in exchange for receiving an up front fee, must stand ready to purchase the security on demand by the holder, in accordance with the terms of the option contract.

Because the market value of a put option on a GNMA, FNMA, or FHLMC security may be expected to rise with an increase in market interest rates, such an option is considered “term insurance” against an increase in market interest rates from the time the rate is committed to the member during loan application to the time the loan is sold on the secondary market.

Under the regulation, a federal credit union may purchase put options if:

a) The related loans are to be sold on the secondary mortgage market within 90 days of closing;

b) The positions are entered into through a contract market designated by the Commodity Futures Trading Commission or with a primary dealer in government securities;

c) The positions are entered into through written policies that meet the minimum requirements contained in the regulation; -

d) The credit union has received permission from the appropriate Regional Director to engage in options transactions; and

e) The transactions are accounted for in accordance with standards established under GAAP to the extent not inconsistent with NCUA Board instructions.

6060.10 OBJECTIONABLE INVESTMENT PRACTICES

Federal credit union directors are responsible for prudent administration of investments in securities. An investment portfolio traditionally has been maintained to provide earnings, liquidity, and a means of diversifying risks.

When investment transactions are entered into in anticipation of taking gains on short-term price movements, the transactions are no longer characteristic of prudent investment activities and should be conducted in a securities trading account. Securities trading of the types described in this section will be viewed as unsuitable activities when they are conducted in a financial institution's investment account. Securities trading should take place only in a closely supervised trading account and be undertaken only by institutions that have the expertise and strong capital and current earning positions.

Trading in the investment portfolio is characterized by a high volume of purchase and sale activity, which, when considered in light of a short holding period for securities, clearly demonstrates management's intent to profit from short-term price movements. In this situation, a failure to follow accounting and reporting standards applicable to trading accounts may result in a misstatement of the financial institution's income and a filing of false regulatory reports and other published financial data.

It is an unsafe and unsound practice to record and report holdings of securities that result from trading transactions using accounting standards which are intended for investment portfolio transactions; therefore, the discipline associated with the accounting standards applicable to trading accounts is necessary. Securities held in trading accounts should be marked to market periodically with unrealized gains or losses recognized in current period income. Prices used in periodic reevaluations should be obtained from sources that are independent of the securities dealer doing business with the institution.

The following practices are considered to be unsuitable when they occur in a financial institution's investment portfolio.

Gains Trading-"Gains trading" is a securities trading activity conducted in an investment portfolio. often termed "active portfolio management." "Gains trading" is characterized by the purchase of a security as an investment and the subsequent sale of that same security at a profit within several days or weeks. Those securities initially purchased with the intent to resell are retained as investment portfolio assets if they cannot be sold at a profit. These "losers" are retained in the investment portfolio because investment portfolio holdings are accounted for at cost, and losses are not recognized unless the security is sold. "Gains trading" often results in a portfolio of securities with extended maturities, lower credit quality, high market depreciation and limited practical liquidity.

In many cases, "gains trading" has involved the trading of "when-issued" securities and "pair-offs" or "corporate settlements" because the extended settlement period associated with these practices allows speculators the opportunity for substantial price changes to occur before payment for the securities is due.

When-Issued Securities Trading-"When-issued" securities trading is the buying and selling of securities in the interim between the announcement of an offering and the issuance and payment date of these securities. A purchaser of a "when issued" security acquires all the risks and rewards of owning a security and may sell the "when-issued" security at a profit before taking delivery and paying for it.

Frequent purchases and sales of securities during the "when-issued" period generally are indications of trading activity and should not be conducted in a credit union's investment portfolio. Federal credit unions engaging in when-issued securities trading must follow NCUA's regulation on cash forward agreements.

Pair-Offs-A "pair-off" is a security purchase transaction which is closed out or sold at, or prior to, settlement date. As an example, an investment portfolio manager will continue to purchase a security; then, prior to the predetermined settlement date, the portfolio manager will "pair-off" the purchase with a sale of the same security prior to, or on, the original settlement date. Profits or losses on the transaction are settled by one party to the transaction remitting to the counter party the difference between the purchase and sale price.

Like "when-issued" trading, "pair-offs" permit speculation on securities price movements without paying for the securities. Pair-off transactions using cash forward agreements are impermissible for federal credit unions. According to NCUA's regulation, cash forward agreements (settlement occurring between 30-120 days) must be settled on a cash basis.

Corporate Settlement on US. Government and Federal Agency Securities Purchases-Regular-way settlement for transactions in U.S. Government and Federal agency securities is one business day after the trade date. Regular-way settlement for corporate securities is five business days after the trade date. The use of a settlement method (5 business days) for U.S. Government securities purchases appears to be offered by dealers in order to facilitate speculation on the part of the purchaser.

Repositioning Repurchase Agreements-Dealers who encourage speculation through the use of "pair-off", "when-issued" and "corporate settlement" transactions often provide the financing at settlement of purchased securities which cannot be sold at a profit. The buyer purchasing the security pays the dealer a small "margin" that is equivalent roughly to the actual loss in the security. The dealer then agrees to fund the purchase by buying the security back from the purchaser under a resale agreement. Apart from imprudently funding a longer-term, fixed-rate asset with short-term, variable-rate source funds, the purchaser acquires all the risks of ownership of a larger amount of depreciated securities for a very small margin payment. Purchasing securities in these circumstances is inherently speculative and is a wholly unsuitable investment practice for credit unions.

6060.11 INVESTMENT TRADING POLICIES

The board of directors of a federal credit union that intends to engage in securities trading should develop and adopt a written trading account policy that includes, at a minimum, the following provisions:

a) Individuals who have purchase and sale authority;

b) Trading account size limitations;

c) Allocation of credit union's cash flow to trading accounts;

d) Stop-loss or sale provisions;

e) Dollar-size limitations of specific types, quantities and maturities to be purchased;

f) Monthly market price adjustments;

g) Limits on the length of time an investment may be inventoried in the trading account;

h) Monthly reports to the Board of all purchase and sale transactions and the resulting gain or loss to be reported on an individual basis. Purchases and sales shall be reported at trade date;

i) A prohibition against the use of a broker/ securities dealer in purchase or sales transactions unless, prior thereto, the credit union has in its files evidence of the broker/dealer's financial responsibility and capability, and management has made reasonable inquiries concerning the broker/ dealer's reputation;

j) A requirement that any security purchased for trading purposes will be recorded at market value on the trade date; and

k) Requirements with respect to securities transfers between the credit union's investment and trading accounts:

   1) The securities being transferred shall be revalued to the current fair value;

   2) That any adjustment in connection with transfer of a security shall be accounted for consistent with section 6060.1.4, "Transfers Between Categories".

   3) No transfers shall be made between categories unless transfer of the security is consistent with previously established investment portfolio policies and objectives. Such transfers are unusual and should be rare.

6061 INVESTMENT CONSIDERATIONS

6061.1 RESPONSIBILITY

The board of directors is responsible for the investment of credit union funds, other than loans to members, in accordance with Section 113 of the Federal Credit Union Act (Act). In general, these investments are limited to those authorized by Section 107(7), 107(8) and 107(15) of the Act. Additionally, Part 703 of the National Credit Union Administration Rules and Regulations and various NCUA Interpretive Ruling and Policy Statements impose additional limitations and/or requirements.

The board of directors must establish policies and procedures to ensure that the credit union's overall financial objectives are being met and that the investment program will provide adequate liquidity, safety and yield to the credit union. To achieve these goals, the board will need to give attention to the following investment considerations:

A federal credit union's ability or inability to make a quick decision to purchase or sell an investment could result in a gain or loss of thousands of dollars. By the same token, a quick decision to invest in a security or enter into a transaction that management does not understand could result not only in potential losses, but also long-term liquidity problems.

A sound investment policy facilitates purchases and sales of securities while assuring their safety. Each security, investment and type of transaction should be analyzed, approved by the board of directors and formally addressed in the investment policy manual. The investment policy should consider the following:

a) U.S. Government and federal agency securities vary in guarantee, yield, interest rates and maturities. Some may not meet the overall needs and objectives of the credit union. The investment policy should list disapproved, as well as approved investments. Any new issue should be presented to the board with an appropriate prospectus and background information before decisions are made.

b) Shares, deposits, or investments in savings and loan associations, banks and credit unions may present a risk not generally recognized, especially when investments exceed insured limits. A thorough review of these institutions' financial statements before investment should disclose any undue risk, and periodic review after the investment should be required. The manual should also specify any limitation or restriction of these investments.

c) All other investments should be reviewed on an individual basis and cited in the investment policy. A sound investment policy addresses the need to facilitate purchases and sales of securities and to enter into safe investment transactions. In many credit unions, this means delegating the responsibility for individual approvals to either an executive or investment committee. This should be done carefully. The right to delegate is not the right to abdicate. Clear written guidelines outlining the delegated authority will ensure that the board's policies are carried out.

In some cases, an individual may be authorized to invest or divest funds in specific investments on a continuing basis, such as in a common trust whenever the checking account balance is in excess of a specified balance. Additionally, an individual may be assigned to advise a broker of the board's decision to purchase an investment or to sign documents. Investment policy should make clear that these responsibilities are not a "carte blanche" authorization to invest credit union funds.

The type of funds management employed by a credit union depends upon its size, resources, volume of activity, and management expertise. Generally, the more detailed the concept, the better control the credit union has over its ability to meet member needs.

6061.2 SPECIAL CONSIDERATIONS

There are certain factors which must be considered when integrating investment policy into overall goals and objectives. These factors are liquidity, safety and yield.

6061.2.1 LIQUIDITY

Investment policy must be flexible enough to allow for changes in the balance sheet items that represent member needs, i.e., shares and loans. As such, investment practices can be considered a function of share and loan behavior. Each time there is a shift in either share or loan volume, there may exist a need to shift investment strategy.

Suppose, for example, the board of directors decides to expand loan policies by offering longer term loans to meet member needs. This will result in a slower turnover of funds, and thus will expand the loan portfolio. If share deposits cannot be expected to meet the increased loan demand, investment policies must reflect a change. In this case, the credit union would probably shorten investment maturities to meet the expected loan demand.

Another factor which would affect Liquidity is the movement and direction of interest rates. As they increase, the value of long-term securities decreases. Thus a credit union with long-term securities during a period of increasing interest rates would become illiquid unless the loss incurred through their sale could be absorbed.

6061.2.2 SAFETY

Despite being limited by law to investments that are primarily guaranteed as to principal and interest, certain investment risks do exist for Federal credit unions. These risks include:

a) Market risk-a possible reduction in value resulting from changes in market demand.

b) Interest rate or maturity risk-a possible reduction in value resulting from increases in interest rates.

c) Credit risk-a possible loss if the issuer of an investment defaults. (This could result from imprudent investments in savings and loan associations and banks in excess of insured limits, or investments in credit unions.)

d) Price-level risk-a possible reduction in purchasing power of the dollar as a result of inflation.

Federal credit unions can reduce investment risks by fully evaluating each type of investment prior to purchase, including the issuer, analyzing the financial condition and reputation of any intermediary to the transaction, such as a broker/dealer; and diversifying the investment portfolio by type, maturity, geographical location, guarantor, etc.

6061.2.3 YIELD

Only after liquidity and safety are considered should investment analysis center on yield. As a general rule, investments with higher risk factors and greater price volatility <u>command</u> the greater yield. Thus the potential for greater income must be weighed very carefully against the risks of reduced liquidity and/or potential losses.

6061.3 AUTHORIZED BROKER/DEALERS

The credit union's investment policies should identify all institutions and dealers/brokers with whom the board of directors and/or investment committee/officer are authorized to transact investments. Approval of institutions and dealers/ brokers should be preceded by a thorough analysis of their financial stability, services provided, responsiveness, and reputation. The credit union should formalize its relationship with investment institutions and specifically identify which credit union officials are authorized to transact credit union investments. Contractual arrangements with investment institutions should be reviewed at least annually. Additional information and guidance relative to the selection of securities dealers is contained in NCUA Interpretive Ruling and Policy Statement No. 88-1; Policy on Selection of Security Dealers and Unsuitable Investment Practices.

6061.4 REPORTING REQUIREMENTS

The investment policy should specifically state the types of reports required by the board to make investment decisions. These reports may include a summary of investments by type, maturity, size or concentration. Additionally, executive and/ or investment committees should prepare a monthly list of all investments which they authorized and any significant occurrences during that period.

6061.5 INTERNAL CONTROLS

The investment policy should require that adequate internal controls are established to separate the responsibilities for approving, disbursing, reconciling and accounting for investment activities. A flow chart depicting these responsibilities may be needed.

6061.5.1 SURETY ASPECTS

The investment policy should give consideration to the maximum amount of coverage and other possible limitations contained in the surety bond. However, the board should not rely on the expectation of surety coverage as a substitute for sound and prudent investment policies.

6061.5.2 SAFEKEEPING

The board should establish investment policies which will protect securities held in safekeeping. The policies require that:

a) All securities not in the physical possession of the credit union should be held in a third party (a bank or other financial institution) safekeeping account. A separate trust division of a bank acting as a dealer qualifies as a third party safekeeping institution.

b) All securities held in safekeeping account, cost and service should be considered. The broker's bank may be used for safekeeping services. However, safekeeping agreements should provide that all transactions will be ordered only by a duly authorized employee or official of the credit union. If the safekeeping institution is to be used to transmit credit union funds for purchases of securities, the agreement should provide that the funds will not be transferred until the securities are received by the institution.

In establishing a safekeeping account, cost and service should be considered. The broker's bank may be used for safekeeping services. However, safekeeping agreements should provide that all transactions will be ordered only by a duly authorized employee or official of the credit union. If the safekeeping institution is to be used to transmit credit union funds for purchases of securities, the agreement should provide that the funds will not be transferred until the securities are received by the institution.

Safekeeping services should be covered by a "bailment for hire" contract. Under this arrangement, the institution, for a fee, agrees to exercise ordinary care in protecting the securities held in safekeeping. Unless specifically covered by statute or contract, the institution is not an insurer of the securities. It is liable only for negligence in caring for and protecting the securities.

6061.6 PERIODIC REVIEW POLICY

The investment policy should be reviewed by the board of directors at least annually. This should ensure that policies and procedures are kept current and that the officials remain in control of the investment program.

6070 FIXED ASSETS

6070.1 FCU OWNERSHIP OF FIXED ASSETS

Federal credit unions have the power to purchase, hold and dispose of property necessary or incidental to their operations. However, Section 701.36 of the National Credit Union Administration Rules and Regulations places some limitations on amounts which may be invested in fixed assets and on the sources from which real property can be acquired without prior approval of the National Credit Union Administration Board.

6070.2 AMOUNT OF INVESTMENTS IN FIXED ASSETS

Prior approval of the National Credit Union Administration Board is required before any federal credit union having $1,000,000 or more in assets may invest in fixed assets if the aggregate of all such investments exceed 5 percent of shares and retained earnings. Section 701.36 of the NCUA Rules and Regulations defines shares to mean all savings (regular shares, share drafts, share certificates, other shares) and retained earnings to include the regular reserves, reserve for contingencies, supplemental reserves, reserves for losses, and undivided earnings. For example, a federal credit union with total shares and retained earnings of $3,000,000 cannot invest more than $150,000 in fixed assets without the National Credit Union Administration's approval.

If a federal credit union desires to invest in fixed assets exceeding 5 percent of its shares and retained earnings, Section 701.36 of the NCUA Rules and Regulations, requires that the federal credit union submit such statements and reports as the NCUA regional director may require in support of the investment. These investments and reports should include but will not be limited to, the following:

a) The purpose of investing in the fixed assets, and a narrative describing how the fixed assets will enhance the credit union's overall operation. For example, if a building is to be purchased or leased, the narrative would include such items as the amount of increased floor space, a plan detailing how the additional floor space will be utilized, comments concerning accessibility of the new location by the current field of membership, and comments on how the purchase will be financed.

b) The credit union's ratio of fixed assets to total shares and retained earnings with and without the proposed investment, and the percentage increase in fixed assets that the proposed investment represents.

c) Estimated additional monthly operating costs and the estimated loss of investment income that will result when investments are used to purchase a fixed asset.

d) A cash flow analysis with and without the proposed investment in order to determine what impact the investment will have on liquidity.

e) A narrative addressing the impact that local economic factors will have on the credit union's performance based upon the assumption that the proposed investment will be approved.

f) A current balance sheet and income statement.

g) Projected year-end balance sheets and income statements for the next 5 consecutive calendar years. Projections should be based on growth rates that can be realistically attained, and reflect the impact of the fixed asset investment. The assumptions used to develop the projections need to be made a part of the balance sheets and income statements.

If the regional director determines that the proposal will not adversely affect the credit union, an aggregate dollar amount or percentage of assets will be approved for investment in fixed assets. Once such a limit has been approved, and unless otherwise specified by the regional director, a federal credit union may make future acquisition of fixed assets provided the aggregate of all such future investments in fixed assets does not exceed an additional 1 percent of the shares and retained earnings over the amount approved.

Federal credit unions shall submit their requests to the National Credit Union Administration's regional office having jurisdiction over the geographical area in which the credit union's main office is located. The regional office shall inform the requesting credit union in writing of the date the request was received. If the credit union does not receive notification of the action taken on its request within 45 calendar days of the date the request was received by the regional office, the credit union may proceed with its proposed investment in fixed assets.

6070.3 PREMISES

When real property is acquired for future expansion, at least partial utilization should be accomplished within a reasonable period, which shall not exceed 3 years, unless otherwise approved in writing by the National Credit Union Administration. After real property for future expansion has been held for 1 year, a board resolution with definitive plans for utilization must be available for inspection by an NCUA examiner.

Investments in premises should be recorded on the credit union's books at historical costs. Historical cost is the actual amount paid at the date of acquisition, including all normal expenditures of readying an asset for use. The cost of land shall be carried on the books of the credit union in an account separate from the cost of improvements thereon. Unless otherwise approved in writing by the National Credit Union Administration Board, the cost of improvements shall be amortized over their estimated useful life, through periodic charges to depreciation expense, such as straight-line or declining balance methods. The reverse sum-of-the-years digits method is not acceptable. The estimated useful life shall conform to guidelines prescribed by the National Credit Union Administration Board. Refer to Section 4050.4, Account No. 772, "Building," in this manual for a listing of acceptable useful lives for buildings.

For purposes of determining the periodic depreciation charge, it is recommended that the salvage value be limited to 10 percent of the cost of the depreciable property (excluding the cost of land) unless a higher salvage value is determined by an independent qualified appraiser at the time of acquisition.

For premises being acquired through a lease agreement refer to Section 6080, Accounting for Leases, in this manual.

A federal credit union shall endeavor to dispose of "abandoned premises" at a price sufficient to reimburse the credit union for its investment and costs of acquisition. Current documents must be maintained reflecting the credit union's continuing and diligent efforts to dispose of "abandoned premises." After "abandoned premises" have been on the credit union's books for 4 years, the property must be publicly advertised for sale. Disposition must occur through public or private sale within 5 years of abandonment, unless otherwise approved in writing by the Administration.

6070.4 PROHIBITED TRANSACTIONS

With the exception of a short term informal lease agreement (maturity less than 1 year) no federal credit union may acquire or lease premises without the prior written approval of the Administration from any of the following:

a) A director, member of the credit committee or supervisory committee, official or employee of the federal credit union, or immediate family member of such director, member of the credit committee or supervisory committee, official or employee.

b) A corporation in which any director, member of the credit committee or supervisory committee, official or employee, or immediate family member of such director, member of the credit committee or supervisory committee, official or employee, is an officer or director, or has a stock interest of 10 percent or more.

c) A partnership in which any director, member of the credit committee or supervisory committee, official or employee, or immediate family member of such director, member of the credit committee or supervisory committee, official or employee is a general partner, or a limited partner with an interest of 10 percent or more.

6070.5 FURNITURE, FIXTURES AND EQUIPMENT

Investments in furniture, fixtures, and equipment should be recorded on the credit union's books at historical cost. The cost of the computer hardware and software should be carried on the books of the credit union in a subsidiary account separate from other items of furniture, fixtures, and equipment.

The cost of furniture, fixtures, and equipment shall be amortized over the estimated useful life through periodic charges to depreciation expense using any of the generally accepted methods of depreciation, except the reverse sum-of-the-years digits method.

Refer to Section 5120.2 of this Accounting Manual for a listing of acceptable uses for furniture and equipment.

6070.6 DEPRECIATION OF FIXED ASSETS

6070.6.1 STRAIGHT LINE

This method is the most popular among credit unions. The remaining amount is divided by the useful life of the asset, and that amount is the yearly depreciation expense. The amount of the depreciation will remain the same until the asset has been depreciated down to salvage value.

To illustrate this method, assume that the credit union purchases an asset for $10,000 with a useful life of 5 years. The estimated average value of the assets is $1,000. The yearly depreciation would be $1,800 computed as follows:

Cost of Asset:	$10,000
Less Salvage Value:	1,000
Depreciable Amount:	$ 9,000

Depreciation, 19X1	$1,800	($9,000/5 = $1,800)
Depreciation, 19X2	$1,800	($9,000/5 = $1,800)
Depreciation, 19X3	$1,800	($9,000/5 = $1,800)
Depreciation, 19X4	$1,800	($9,000/5 = $1,800)
Depreciation, 19X5	$1,800	($9,000/5 = $1,800)

If an asset is purchased or sold during the year, it becomes necessary to expense only a portion of the yearly depreciation expense. To illustrate, assume that the above asset was purchased on October 1, 19 X 1. The amount of the expense for that first year would only be $450 ($1,800 x 3/12).

Instead of computing depreciation on a yearly basis, months can be substituted for years. Instead of computing a yearly depreciation rate, the credit union can compute a monthly rate by dividing the cost of the asset (less salvage value) by the number of months in the useful life. In the above example, the monthly rate of depreciation would be $150, ($9,000 / 60 months = $150).

6070.6.2 SUM OF THE YEARS DIGITS

This method is designed to provide more depreciation expense in the first few years of ownership and less in the last few years. This is called an accelerated method of depreciation. It is most useful in leveling out expenses over the life of an asset. As an asset ages, repair and maintenance costs increase. An accelerated depreciation method should provide high depreciation costs when repair costs are low and low depreciation costs when repair costs are high. Total costs for an asset (depreciation and repairs and maintenance) should then remain somewhat level over its useful life.

To compute depreciation under the sum of the years digits method, the cost of an asset (less salvage value) is multiplied by a fraction each year to determine that year's depreciation expense.

The denominator (bottom line) of this fraction is the sum of each of the years in the useful life of an asset. If the useful life of an asset is 3, then the sum of the years is 6 (3 + 2 + 1). If the useful life of an asset is 4, then the sum of the years is 10 (4 + 3 + 2 + 1). This part of the fraction will stay the same each year.

The numerator (top number) of this fraction is the number of years of useful life remaining for the asset. This part of the fraction will change each year.

Example 1: Assume a $10,000 asset with a useful life of 5 years and a salvage value of $1,000. The depreciation expense is computed as follows:

	Fraction Amount	Depreciable Amount	Depreciation Expense
Depreciation 19X1	5/15	$9,000	$3,000
Depreciation 19X2	4/15	$9,000	2,400
Depreciation 19X3	3/15	$9,000	1,800
Depreciation 19X4	2/15	$9,000	1,200
Depreciation 19X4	1/15	$9,000	600
Total Depreciation			$9,000

The fractions for the following years are:

Year	4 Year Useful Life	5 Year Useful Life	6 Year Useful Life
1	4/10	5/15	6/21
2	3/10	4/15	5/21
3	2/10	3/15	4/21
4	1/10	2/15	3/21
5	—	1/15	2/21
6	—	—	1/21

Months (or quarters) may be substituted for years if the credit union elects to compute monthly (or quarterly) depreciation.

When a credit union computes depreciation on a yearly basis, it becomes necessary to record only a portion of that depreciation in the year of purchase and in the year of sale of the asset. This can be done by months or by days.

Assume that the credit union purchases an asset on April 1, 1981. The asset, cost $12,500, has a salvage value of $500 and a useful life of 3 years, and the credit union elects to use the sum of the years digits method of depreciation. Since the asset was purchased one-fourth of the way through the first year, only three-fourths of the depreciation should be taken in the first year, the remainder should be taken in the second year. Each additional year must also be allocated as well.

Year	Fraction	Depreciable Amount	Depreciable Expense
1	3/6	$12,000	$ 6,000
2	2/6	12,000	4,000
3	1/6	12,000	2,000
Total Depreciation Expense			$12,000

Calendar Year	1981	1982	1983	1984
1st year 3/4 x 6,000	4,500			
1st year 1/4 x 6,000		1,500		
2nd year 3/4 x 4,000		3,000		
2nd year 1/4 x 4,000			1,000	
3rd year 3/4 x 2,000			1,500	
3rd year 1/4 x 2,000				500
Total Expense for Year	$4,500	$4,500	$2,500	$500

6070.6.3 DECLINING BALANCE

This depreciation method is also an accelerated method of depreciation providing for additional depreciation expense in the early years. Under this method, a fixed percentage is multiplied by the d g balance of the particular asset. The rate of depreciation is a number between 100 and 200 percent of the straight line rate. The following steps should be used to determine depreciation under the declining balance method.

Facts: The credit union purchased an asset for $10,000 with a useful life of 5 years. The estimated salvage value of the asset is $1,000.

a) Determine the straight line rate:

   The straight line rate is determined by the following formula: 1 divided by the useful life of the asset. For example, an asset with a useful life of 5 years would have a straight line rate of 20 percent.

b) Multiply the straight line rate by a percentage between 100 and 200:

   Assume that a credit union wanted to use a rate of 150 percent of the straight line rate. On an asset with a useful life of 5 years, then 150 percent of the straight line rate would be 30 percent (1 divided by 5 has a straight fine rate of 20 percent, and 150% of that rate is 30 percent).

c) Multiply the depreciation rate times the declining balance of the asset (ignoring salvage value until the last year). To determine a years depreciation expense, multiply the depreciation rate times the declining balance (the original cost less prior years depreciation, if any). The declining value must never fall below the estimated salvage value of the asset. Also, in the last year of useful life, the asset must be written down to salvage value.

Purchased 1/1/X1

	Depreciation	Balance
		$10,000
Depreciation, 19X1 ($10,000 x 30%)	$3,000	7,000
Depreciation, 19X2 ($ 7,000 x 30%)	2,100	4,900
Depreciation, 19X3 ($ 4,900 x 30%)	1,470	3,430
Depreciation, 19X4 ($ 3,430 x 30%	1,029	2,401
Depreciation, 19X5 (Writedown to salvage value)	1,401	1,000
Total Depreciation	$9,000	

In the event that an asset is purchased or sold during the year, only a portion of the year's expense should be recorded. In the above example, if the asset has been purchased on July 1, 19 X 1. The depreciation for the first year would be only $1,500 (6/12 x $3,000). In subsequent years, the credit union should continue to use the 30 percent rate against the declining balance to determine the depreciation expense for the year.

6070.6.4 COMPARISON OF THREE METHODS

	Straight Line	Sum of the Year Digits	Declining Balance
Depreciation, 19X1	$1,800	$3,000	$3,000
Depreciation, 19X2	1,800	2,400	2,100
Depreciation, 19X3	1,800	1,800	1,470
Depreciation, 19X4	1,800	1,200	1,029
Depreciation, 19X5	1,800	600	1,401
Total Depreciation	$9,000	$9,000	$9,000

6070.6.5 GAIN OR LOSS IN THE YEAR OF SALE OF AN ASSET

If an asset is sold during the year, a gain or loss will occur unless the asset is sold for book value (the original cost less depreciation). In order to compute this gain or loss, the following steps should be followed:

Record depreciation up to date. Since the asset was sold prior to year end, it is necessary to allocate depreciation up to the date of sale.

Compute book value. The book value is the original cost to the credit union, plus any additions to the asset that have not been expensed, less any depreciation taken to date. This amount is the book value.

Determine proceeds from the sale. This is the amount received by the credit union for the sale of the asset. If the property is abandoned or given away, the proceeds will be zero. If property is received as a part of the sale, the sale may be considered a trade-in. Trade-ins are covered in Section 6070.6.6 (Trade-in).

Determine gain or loss. If the proceeds from the sale is greater than the computed book value, the sale is a gain. The gain is the difference between the proceeds and the book value. The following entry should be prepared to record the sale and remove the asset from the books of the credit union.

Dr. - Allowance for Depreciation of Furniture and Fixtures (Acct. No. 775)	XXXXX	
Dr. - Cash (Acct. No. 731)	XXXXX	
Cr.-Furniture and Fixtures (Acct. No. 774)		XXXXX
Cr.-Gain (Loss) on Disposition of Assets (Acct. No. 430)		XXXXX

If the proceeds from the sale is less than the computed book value, then the sale is a loss. The loss is the difference between the proceeds and the book value. The following entry should be prepared to record the sale and remove the asset from the books of the credit union.

Dr. - Allowance for Depreciation
of Furniture and Fixtures
(Acct. No. 775) XXXXX
Dr. - Cash (Acct. No. 731) XXXXX
Cr.-Gain (Loss) on Disposition
of Assets (Acct. No. 430) XXXXX
Cr.-Furniture and Fixtures
(Acct. No. 774) XXXXX

6070.6.6 TRADE-IN

In some cases when a new asset is purchased, the credit union will exchange or trade-in the current asset. This is common with computer equipment. Unless the book value and the fair market value are equal, the credit union must record a gain or loss on this exchange. This gain or loss should be computed as the difference between the fair market value and the book value of the equipment given up. It is not adequate to obtain the vendor's statement as to the fair market value of the asset. An independent determination of the value is necessary. The following steps are used when current asset are traded:

a) *Record depreciation up to date.* If the asset was traded in prior to year end, it is necessary to allocate depreciation up to the date of the trade-in.

b) *Compute book value.* The book value is the original cost to the credit union, plus any additions to the asset that have not been expensed, less any depreciation taken to date. This amount is the book value.

c) *Determine fair market value of the asset given up*.

d) *Determine gain or loss.* If the book value of the asset traded-in is greater than the fair market value of that asset, a loss has occurred. The following entry should be recorded when an asset has been traded in for a new asset and a loss has occurred:

Dr. - Allowance for Depreciation
of Furniture and Fixtures
(Acct. No. 775) XXXXX
Dr. - Furniture and Fixtures
(Acct. No. 774) (new) XXXXX
Dr. - Gain (Loss) on Disposition
of Assets (Acct. No. 430) XXXXX
Cr.-Furniture and Fixtures
(Acct. No. 774) (old) XXXXX
Cr.-Cash (Acct. No. 731) XXXXX

If the book value of the asset traded-in is less than the fair market value of that asset, a gain has occurred, and the following entry should be recorded to reflect the trade-in of the old asset for a new asset and the gain on the exchange:

Dr. - Allowance for Depreciation of Furniture and Fixtures (Acct. No. 775)	XXXXX	
Dr. - Furniture and Fixtures (Acct. No. 774) (new)	XXXXX	
Cr.-Furniture and Fixtures (Acct. No. 774) (old)		XXXXX
Cr.-Gain (Loss) on Disposition of Assets (Acct. No. 430)		XXXXX
Cr.-Cash (Acct. No. 731)		XXXXX

The book value of the new asset will be the fair market value of the asset given up plus any cash paid or debt incurred.

6070.6.7 COMPOSITE DEPRECIATION METHOD

This method allows economic lives to be applied to broad classes of assets rather than to detailed items of depreciable property. Composite or group depreciation is a process of averaging the economic lives of a number of property units and taking depreciation on the entire group as if it were a unit. The depreciation rate is computed determining the depreciation for 1 year for each item or each group of similar items and dividing the total depreciation thus obtained by the total cost or other basis of the assets. This average rate is to be used as long as later additions, requirements, or replacements do not substantially alter the relative proportions of different types of assets in the accounts. An example of the computation of a composite rate under the straight-fine method follows:

On January 2, a desk was brought for $500. It has an estimated useful life of 10 years. A calculator was also purchased for $500. The life was 5 years. Estimated salvage value was 20% of cost on both items. The average rate of depreciation is computed as follows:

Asset	Date Acquired	Original Cost	Estimated Salvage Value	Amount To Be Depreciated	Annual Economic Life	Annual Depreciation
Desk	1/2	$ 500	$100	$400	10	$ 40
Calculator	1/2	500	100	400	5	80
		$1,000	$200	$800		$120

(Average rate of depreciation ($120 divided by $1,000) = 12%)

6080 LEASES

The discussion and examples contained in this section are designed to provide a basic understanding of the Generally Accepted Accounting Principles applicable to leases. This section does not address all of the variations and complications that a lease may involve.

The management of a credit union considering entering into an extensive or complicated lease should obtain the opinion of an independent accountant concerning the correct accounting procedures and disclosures applicable to the particular lease.

The credit union management should also obtain an opinion from a competent attorney concerning the legality of entering into such a lease before making the final decision to do so.

6080.1 DEFINITIONS

Estimated Economic Life. The estimated remaining period during which the property is expected to be usable for the purpose for which it was designed, with normal repairs and maintenance, without limitation by the lease term.

Incremental Borrowing Rate. The rate of interest that the lessee would have had to pay at the beginning of the lease to borrow the funds, on similar terms, to purchase the leased property.

Interest Rate Implicit In The Lease. The rate used by the lessor to determine the amount of the lease payments. This rate can be derived by the lease terms using a present value computation of the minimum lease payments, or, in some cases, may be supplied by the lessor to the lessee.

Minimum Lease Payments. The payments the lessee is obligated to make, or can be required to make, over the length of the lease, such as the total of the periodic lease payments, any guarantee by the lessee of residual value, any payment agreement upon failure to renew or extend the lease, and the payment required by a bargain purchase option.

6080.2 LEASE CLASSIFICATIONS FOR LESSEES

From the standpoint of the lessee, there are two major categories of leases: capital and operating. A capital lease, generally, is one which transfers substantially all of the benefits and risks of ownership of the asset, and, specifically, meets one of the four criteria listed below. An operating lease is a rental of property, meeting none of the criteria listed below.

6080.2.1 CAPITAL LEASES

A lease meeting one of the following criteria is a capital lease.

a) The lease transfers ownership of the property to the lessee by the end of the lease term.

b) The lease contains an option to purchase the leased property at a bargain (below fair value) price.

c) The lease term is equal to or greater than 75% of the estimated economic life of the leased property.

d) The present value of the minimum lease payments equals or exceeds 90% of the fair market value of the leased property less any investment tax credit retained by the lessor.

The last two criteria are not applicable when the beginning of the lease term falls within the last 25 percent of the total estimated economic life of the leased property.

To compute the present value of the lease payments specified in item d, the lessee will use its incremental borrowing rate unless the lessee is aware of the lessor's interest rate implicit in the lease, and the implicit rate is less than the lessee's incremental rate.

6080.2.2 ACCOUNTING PROCEDURES - CAPITAL LEASES

Leases involving land and building are discussed separately. See section 6080.10.

Capital leases should be accounted for as an acquisition of a depreciable asset and the assumption of a liability by the lessee. The following example demonstrates the accounting entries used to record a lease.

XYZ Credit Union has decided to lease computer hardware. The terms of the lease specify that the credit union will make monthly payments of $254.65 for four years. At the end of the lease, the credit union may purchase the hardware for $500.

The fair market value of the hardware is $10,000. To purchase the equipment outright, the credit union would have to borrow at an interest rate of 13%. The lessor has informed the credit union that the interest rate used to determine the lease terms was 12%.

The credit union determines that the lease is a capital lease because of the bargain purchase option in the lease. In addition, the credit union uses the following computation to determine that the minimum lease payments are at least 90% of the fair market value of the hardware.

Monthly lease rentals: $262.65 x present value of an annuity due (payments made at the start of the payment period) of 48 rents at 1% per period or $262.65 x 36.89	$9,690
Plus: Bargain purchase price: $500 x present value of $1 discounted for 48 periods at 1% per period or $500 x .62	$310
Total present value of minimum lease payments	$10,000

Fair Market Value of Computer Hardware	$10,000
Present value of minimum lease payments as a percentage of fair market value	100%

The credit union normally would have used 13% (the Incremental Borrowing Rate; see Definitions) to determine the present value of the minimum lease terms. However, the credit union knew that the interest rate used by the lessor to determine the lease terms was 12%. Since the credit union knew the interest rate used by the lessor, and since this rate was less than the credit union's Incremental Rate, it used 12% (1% per month) to determine the present value of the minimum lease payments.

The asset (lease) should be recorded by the credit union at the lesser of the present value of the minimum lease payments or at the fair value of the item leased. In this example, the amounts are the same, $10,000.

To record the lease:

Dr. - Leased Hardware - Capital Lease (Acct. No. 778)	$10,000	
Cr.-Obligations under Capital Lease (Acct. No. 863)		$10,000

To record the first month's payment:

Dr. - Obligation under Capital Lease (Acct. No. 863)	$252.65	
Cr.-Cash (Acct. No. 730)		$252.65

To record the second month's payment and interest expense:

The interest expense is ($10,000-$252.56) x 1%, or $97.47

Dr. - Interest Expense (Acct. No. 342)	$97.47	
Dr. - Obligation under Capital Lease (Acct. No. 863)	155.18	
Cr.-Cash (Acct. No. 730)		$252.65

The credit union will amortize the lease using its normal method of depreciation for fixed assets. In this example, straight line depreciation is used.

If the lease specifies that the ownership of the property will transfer to the lessee by the end of the lease, or if the lease provides for a bargain purchase option, the credit union will amortize the lease over the useful life of the property. In this example, five years is used.

If the lease does not meet either of the two criteria stated above, then the lease will be depreciated over the term of the lease.

To record the monthly depreciation expense (the salvage value is determined to be $100):
$10,000 - $100/60 months = $165.00

Dr. - Depreciation Expense for
Leased Assets (Acct. No. 257) $165
Cr.-Allowance for Depreciation of
Leased Assets (Acct. No. 779) ....
$165

6080.2.3 REQUIRED DISCLOSURES - CAPITAL LEASES

The lessee will disclose the following information:

a) The gross amount of assets recorded under capital leases as of the balance sheet date.

b) Future minimum lease payments as of the balance sheet date.

c) The total of minimum subleases, if any, to be received in the future as of the balance sheet date.

d) Total contingent rentals actually incurred for each period presented.

e) Assets recorded under capital leases and the accumulated amortization of those assets.

6080.3 OPERATING LEASES

Any lease not meeting at least one of the four criteria cited in 6080.2.1 is an operating lease.

6080.3.1 ACCOUNTING PROCEDURES - OPERATING LEASES

Normally, rents on an operating lease shall be charged to expense over the lease term. Rental expense will be recognized on a straight line basis unless another systematic and rational basis is more representative of the time period in which the benefit is derived.

As an example, XYZ Credit Union rents **a** typewriter for three months while their typewriter is being repaired. Total rental is payable at the beginning of the lease.

To record the payment of the lease:

Dr. - Prepaid Expenses
(Acct. No. 769) $120
Cr.-Cash (Acct. No. 730) $120

To record the expense of the rental each month for the three months:

Dr. - Other Operation Expense
(Acct. No. 269) $40
Cr.-Prepaid Expenses
(Acct. No. 769) ....
$40

6080.3.2 REQUIRED DISCLOSURES OPERATING LEASES

The lessee will disclose the following information for all operating leases:

a) Rental expenses for each period in which an income statement is presented.

b) A general description of the leasing arrangements.

The lessee will disclose the following information for all leases having initial or remaining noncancelable lease terms in excess of one year:

a) Future minimum rental payments required as of the date of the latest balance sheet.

b) The total minimum rentals to be received in the future under noncancelable subleases.

6080.4 LEASE CLASSIFICATIONS FOR LESSORS

From the standpoint of the lessor, there are four basic types of leases: sales-type leases, direct financing leases, leveraged leases, and operating leases.

6080.5 SALES-TYPE LEASES

In general, a lease that provides for a profit (or loss) is a sales-type lease. That is, the fair market value of the lease as recorded on the lessor's books is different from (greater or less than) the cost or carrying value of the leased property.

Normally, sales-type leases are used by manufacturers as a means of marketing their products. To be a sales-type lease, the lease must meet at least one of the criteria in section 6080.2.1 and both of the following two conditions:

a) Collectibility of the minimum lease payments is reasonably predictable.

b) No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor.

6080.5.1 ACCOUNTING PROCEDURES SALES-TYPE LEASES

The total of the minimum lease payments plus any unguaranteed residual value of the property is recorded as the lessor's gross investment. The difference between the gross investment and the present value of the minimum lease payments and residual value is recorded as unearned income.

6080.6 DIRECT FINANCING LEASES

A direct financing lease must meet at least one of the criteria for a capital lease, (See section 6080.2.1) and the two additional conditions stated above in section 6080.5. A sales-type lease differs from a direct financing lease in that the cost (or carrying value) of the property to be leased is the same as the fair market value of the property.

Credit unions which lease personal property, such as automobiles, make direct financing leases.

6080.6.1 ACCOUNTING PROCEDURES - DIRECT FINANCING LEASES

The sum of the minimum lease payments plus any unguaranteed residual value will be recorded as the gross investment in the lease. The difference between the gross investment in the lease and the cost of the property shall be recorded as unearned income.

For example, XYZ Credit Union purchases a new automobile from a dealer and then leases the automobile to a member. The purchase price of the car is $12,000. The lease terms specify 60 monthly payments of $254.96. Payments are to be made at the end of each period. The interest rate implicit in the lease is 10%. Ownership of the automobile passes to the member at the end of the lease.

This lease qualifies as a direct financing lease for the following reasons:

a) The present value of the minimum lease payments ($12,000) equals or exceeds 90% of the fair market value of the leased property ($12,000). Also, the ownership of the automobile passes to the member by the end of the lease.

b) Collectibility of the minimum lease payments are reasonably predictable. This determination has been made through the creditworthiness evaluation of the member.

c) No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the credit union. The credit union has already paid $12,000 for the car.

d) The carrying value of the automobile ($12,000) is the same as the fair market value of the lease. The credit union paid cash for the automobile, thus establishing fair market value, and the auto is on the credit union's books at the cash price paid.

The following entries will be made by the credit union.

To purchase the automobile:

Dr. - Automobile (Acct. No. 799)	$12,000	
Cr.-Cash (Acct. No. 730)		$12,000

To record the lease:

Dr. - Lease Payments Receivable (Acct. No. 723)	$15,297.60	
Cr.-Automobile (Acct. No. 799)		$12,000.00
Cr.-Other Deferred Credit (Acct. No. 889)		3,297.60

To record the receipt of the first lease payment:

Dr. - Cash (Acct. No. 730)	$254.96	
Cr.-Lease Payments Receivable (Acct. No. 723)		$254.96

To recognize the portion of the unearned income that is earned during the first month of the lease: $15,297.60 x .83% = $127.48

Dr. - Unearned Income (Acct. No. 889)	$127.48	
Cr.-Miscellaneous Operating Income Earned on Leases (Acct. No. 154)		$127.48

The balance in the Lease Payments is used to determine the income recognized each month. For instance, the computation for the second month would be $15,297.60 - $254.96 x .83%, and so on through the term of the lease.

As an alternative, suppose that the same automobile is purchased, but the member will be required to guarantee a $4,000 residual at the end of the 48 month lease term. Assume all other conditions which applied to the preceding example apply to this example as well.

First the discounted value of the $4,000 residual is determined. This value of $4,000 discounted .83% (10% per year divided by 12 months = .83%) for 48 months is $2,685.73.

This value may be determined by discounting the value of $4,000 by .83% for 48 months using a calculator, or by looking up the present value of $1.00 (and multiplying by $4,000) in a present value table. The factor is .6714321. To get the discounted figure, multiply this factor by $4,000.

This value is then subtracted from the $12,000 purchase price of the automobile, giving $9,314.27 as the remaining present value.

This present value is then used to determine the monthly payments. For 48 payments at 10% per year (.83% per month) for a value of $9,314.27, the monthly payments are $236.23.

Note that the present value of the monthly payments and the discounted value of the guaranteed residual add to $12,000, as shown below.

Present value of lease payments receivable	$ 9,314.27
Present value of $4,000 received in 48 months at .83%	$ 2,685.73
Present Value of Total Lease Payments Receivable	$12,000.00

To record the purchase of the automobile:

Dr. - Automobile (Acct. No. 799) $12,000
Cr.-Cash (Acct. No. 730) $12,000

To record the lease:

Dr. - Lease Payments Receivable
(Acct. No. 723) $15,339.04
Cr.-Automobile (Acct. No. 799) $12,000.00
Cr.-Other Deferred Credit (Acct. No. 889) 3,339.04

To record the receipt of the first lease payment:

Dr. - Cash (Acct. No. 730) $263.23
Cr.-Lease Payments Receivable
(Acct. No. 723) $263.23

To recognize the portion of the unearned income that is earned during the first month of the lease: $15,399.04 x .83% = $127.31

Dr. - Unearned Income
(Acct. No. 889) $127.31
Cr.-Miscellaneous Operating
Income Earned on Leases
(Acct. No. 154) $127.31

The balance of the Lease Payments Receivable is used to determine the income recognized each month. For instance, the computation for the second month would be $15,339.04 - $236.23=$15,102.81 x .83%=$125.35.

6080.7 LEVERAGED LEASES

A leveraged lease is an arrangement whereby a long-term creditor provides nonrecourse financing for a leasing transaction between the lessee and the lessor. It would be unusual for a credit union to be involved in this type of lease. Accounting for the various aspects of a leveraged lease is quite complex. A credit union would need to obtain expert advice before entering into a lease of this type.

6080.8 OPERATING LEASES

Leases not failing into the three types described above are operating leases. An operating lease does not transfer substantially all of the benefits and risks of ownership to the lessee, and does not meet any of the four criteria in section 6080.2.1.

Rental income will be recognized over the lease term as it becomes receivable according to the provisions of the lease. If rentals are not received on a straight line basis, however, the income will still be recognized on a straight line basis unless another systematic and rational basis is more representative of the time pattern in which the use benefit is diminished. In that case, the alternate basis shall be used.

Initial direct costs associated with the lease will be deferred and expensed over the lease term on the same basis as the income. If the costs are immaterial in amount, the credit union may choose to expense them in the period incurred.

6080.9 REQUIRED DISCLOSURES - LESSORS

When leasing is a significant part of the credit union's activities in terms of revenue, net income, or assets, the credit union must make the disclosures listed below.

For all types of leases, the credit union will provide a general description of the lessor's leasing arrangements.

For sales-type and direct financing leases, the credit union will disclose:

a) All components of the net leases as of the date of each balance sheet, such as future minimum lease payment to be received, unguaranteed residual values accruing to the benefit of the credit union, initial direct costs in the case of direct financing leases only, and unearned income.

b) The future minimum lease payments to be received for each of the five succeeding fiscal years as of the date of the latest balance sheet presented.

c) Total contingent rentals included in income for each of the income periods presented in the statements.

For operating leases, the credit union will disclose:

a) The cost and carrying amount, if different, of leased property according to type of property and the amount of depreciation in total as of the date of the latest balance sheet presented.

b) Minimum future rentals on noncancelable leases in total as of the date of the latest balance sheet presented and for each of the five succeeding fiscal years.

c) The total contingent rentals included for each of the income periods included in the statements.

6080.10 LEASES INVOLVING REAL ESTATE

Real estate leases will be discussed under the four categories listed as follows:

a) leases involving land only,

b) leases involving land and building,

c) leases involving real estate and equipment, and

d) leases involving only part of a building.

6080.10.1 CRITERIA FOR CLASSIFYING REAL ESTATE LEASES

To determine the correct accounting procedures for real estate leases, the following criteria must be considered.

a) The lease transfers ownership of the property to the lessee by the end of the lease term.

b) The lease contains an option to purchase the leased property at a bargain price.

c) The lease term is equal to or greater than 75% of the estimated economic life of the leased property.

d) The present value of the minimum lease payments equals or exceeds 90% of the fair value of the leased property less any investment tax credit retained by the lessor.

e) Collectibility of the minimum lease payments is reasonably predictable.

f) No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor.

g) The fair market value of the land equals less than 25% of the total fair market value of the leased property at the inception of the lease. The land and building are considered a single unit for the purposes of applying criteria c and d. The estimated economic life of the building shall be considered the estimated economic life of the unit for determining c.

h) The fair value of the land equals 25% or more of the total fair value of the leased property at the inception of the lease. The land and building shall be considered separately for purposes of applying criteria c and d. The minimum lease payments shall be apportioned in order to determine d. The building element of the lease meets c or d.

i) The fair value of the land equals 25% or more of the total value of the leased property at the inception of the lease. The land and building shall be considered separately for purposes of applying criteria c and d. The minimum lease payments shall be apportioned in order to determine d. The building element of the lease does not meet c or d.

6080.10.2 LEASES INVOLVING LAND ONLY

The following tables identify the accounting treatment to be applied depending on the criteria met.

TABLE 1

If the credit union is a lessee, only a criteria a and b apply

Criteria Met	Special Circumstances	Accounting Procedures
a or b		Treated as a Capital Lease
Neither a nor b		Treated as an Operating Lease

TABLE 2

If the credit union is a lessor, criteria c, d, g, h, and i do not apply to this table.

Criteria Met	Special Circumstances	Accounting Procedures
a	The lease gives rise to a dealer's profit	Treated as a Sales-Type Lease*
a, e, and f	The lease does not give rise to a dealer's profit	Treated as a Direct Financing or a Leveraged Lease as appropri- ate
b, e, and f		Treated as a Direct Financing, Leveraged, or Operating Lease as appropriate
Neither e		Treated as an Operating Lease

* The lease is classified as a sales-type lease. However, the accounting procedures will follow those required for the sale of a property.

6080.10.3 LEASES INVOLVING LAND AND BUILDING

For leases involving both land and building, the criteria g, h, and i will be considered, as well as the other criteria previously considered. These criteria are listed in the previous section, 6080.10, Leases Involving Real Estate.

TABLE 3

If the credit union is a lessee, criteria e and f do not apply to this table.

Criteria Met	Special Circumstances	Accounting Procedures
a or b	Land and building will be separately capitalized and accounted for	Treated as a Capital Lease* **
g and c or d, not a or b	Land and building shall be capitalized as a single unit	Treated as a Capital Lease***
g and not a, b, c, or d		Treated as an Operating Lease
h and not a or b	The land and building will be separately capitalized and accounted for as follows:	
	Building	Treated as a Capital Lease***
	Land	Treated as an Operating Lease
i and not a or b	The land and building will be accounted for as a single unit	Treated as an Operating Lease

* The costs, etc. will be prorated between land and building. The land will not normally be amortized.
** The building will be amortized according to the credit union's normal depreciation policy.
*** The building will be amortized according to the credit union's normal depreciation policy except that the period of amortization shall be the lease period.

This table applies if the credit union is a lessor.

TABLE 4

Criteria Met	Special Circumstances	Accounting Procedures
a only	The lease gives rise to a dealer's profit	Treated as a Sale-Type Lease*
a, e, and f	The lease does not give rise to a dealer's profit	Treated as a Direct Financing or Leveraged Lease as appropriate
a only	The lease does not give rise to a dealer's profit	Treated as an Operating Lease
b only	The lease gives rise to a dealer's profit	Treated as an Operating Lease
b, e, and f	The lease does not give rise to a dealer's profit	Treated as a Direct Financing or as a Leveraged Lease as appropriate
b only	The lease does not give rise to a dealer's profit	Treated as an Operating Lease
g, e, f and c or d; not a or b	The land and building are accounted for as a single unit	Treated as a Direct Financing or as a Leveraged Lease as appropriate

TABLE 4 (Continued)

g only	The land and building are accounted for as a single unit	Treated as an Operating Lease
h, e, and f only	The land and building are accounted for separately	
	Building	Treated as a Direct Financing Lease, as a Leveraged Lease, or as an Operating Lease as appropriate.
	Land	Treated as an Operating Lease
i only	The land and building are accounted for as a single unit	Treated as an Operating Lease

* The lease is classified as a sales-Type Lease. However, the accounting procedures will follow those required for sale of a property.

6080.10.4 LEASES INVOLVING REAL ESTATE AND EQUIPMENT

A credit union will account for the equipment separately from the real estate in all circumstances, regardless of whether it is the lessee or the lessor. The credit union will estimate, by whatever means are appropriate to the circumstances, the minimum lease payments applicable to the equipment. The equipment is to be considered separately for purposes of applying the criteria in the above tables, and is to be accounted for separately according to its classification.

6080.10.5 LEASES INVOLVING ONLY PART OF A BUILDING

Leases involving only part of a building will be accounted for according to the same method as described under Section 6080.10.2 if the cost and fair value of the leased portion of the building are objectively determinable.

In most cases, those factors will not be objectively determinable. When the cost and fair value of the leased area can not be objectively determinable, and the credit union is the lessor, the lease will be accounted for as an Operating Lease.

If the credit union is a lessee, and the cost and fair value of the leased portion of the property cannot be objectively determinable, the credit union must decide if the lease term is equal to or greater than the economic life of the building in which the leased property is located. If so, the credit union will treat the lease as a Capital Lease, and it will amortize the property over the terms of the lease according to the credit union's usual method of depreciation. If not, the lease will be treated as an Operating Lease.

6080.11 SALE AND LEASEBACK TRANSACTIONS

Sale and leaseback transactions involve a sale of property by the serer-lessee and the lease of the property back to the seller by the buyer-lessor.

Credit union involvement in sale and leaseback transactions is addressed by a National Credit Union Administration Interpretive Ruling and Policy Statement (IRPS 81-7).

This IRPS should be reviewed by any federally insured credit union contemplating a sale and leaseback transaction. Auditors and Examiners who encounter such transactions in credit unions should also review this IRPS to ensure adequate knowledge of the accounting treatment of such transactions as they apply to federally insured credit unions.

6080.11.1 ACCOUNTING TREATMENT FOR SALE AND LEASEBACK TRANSACTIONS FOR SELLER-LESSEES

This section will be discussed in terms of sale and leaseback transactions for seller-lessees which do not involve real estate and those which do involve real estate.

A credit union engaging in a bona fide sale and leaseback transaction may recognize an immediate gain (or loss) on the sale only if the terms of the transaction meet one or more of the following conditions:

a) The credit union relinquishes the right to substantially all of the remaining use of the property sold, retaining only a minor portion of such use. In that case, the sale and leaseback will be accounted for as separate transactions based on each of their respective terms. However, if the rental amount is greater than the market at the inception of the lease, a portion of the gain is to be deferred and amortized in an amount which reduces the rentals to market.

b) The credit union retains more than a minor part but less than substantially all of the use of the leaseback property. In that case, the credit union would recognize a profit or loss equal to the difference between the sale price and the present value of the minimum lease payments over the lease term if the lease is classified as an operating lease, or the difference between the sale price and the recorded amount of the lease asset if the leaseback is classified as a capital lease.

c) If the fair value of the property at the time of the sale is less than its undepreciated cost, (carrying value) the credit union will recognize an immediate loss equal to the difference.

If the terms of the sale and leaseback do not meet any of the above conditions, but if the lease meets any of the criteria in 6080.2. 1, the credit union will account for the lease as a capital lease. Any profit on the sale shall be deferred and amortized in proportion to the amortization of the leased asset. A loss on the transaction will be recognized immediately.

6080.11.1.1 ACCOUNTING TREATMENT FOR NON-REAL ESTATE SALE AND LEASEBACK TRANSACTIONS FOR SELLER-LESSEES

Non-real estate sale and leaseback transactions involving all or part of the leaseback property's economic life are accounted for by the seller-lessee as Capital Leases if they meet one or more of the criteria listed in section 6080.10.2, Capital Leases. If they fail to meet any of the said criteria, they are accounted for as Operating Leases.

For a credit union retaining substantially all of the remaining use of the leaseback property, any profit or loss on the sale is to be deferred and amortized in proportion to the amortization of the leased asset, if the transaction is a Capital Lease.

If the credit union retains substantially all of the remaining use of the leaseback property, and if the transaction is an Operating Lease, the profit or loss is to be amortized in proportion to the related gross rental charged to expense over the lease term.

If the credit union does not retain substantially all of the remaining use of the leaseback property, one of the three following applies:

a) If the seller-lessee relinquishes the right to substantially all of the leaseback property, retaining only a minor portion of such use, the sale and leaseback shall be accounted for as separate transactions based on their respective terms. If the amount of rentals agreed upon in the lease is unreasonable under market conditions, an appropriate amount shall be deferred or accrued by adjusting profit or loss on the sale, and amortized as specified above to adjust those rentals to a reasonable amount.

b) If the seller-lessee retains more than a minor part but less than substantially all of the leaseback property and realizes a profit on the sale in excess of either the present value of the minimum lease payments over the lease term, or the recorded amount of the leaseback asset (carrying value), then the profit shall be recognized at the date of the sale. The present value of the minimum lease payments for an operating lease are to be calculated using the rate to apply the 90% recovery criterion (criterion d) of section 6080.10.2, Capital Leases.

c) If the fair value at the time of the transaction is less than the carrying value of the leaseback property, a loss is to be immediately recognized up to the amount of the difference between the carrying value and the fair value of the leaseback property.

6080.11.1.2 ACCOUNTING TREATMENT FOR REAL ESTATE SALE AND LEASEBACK TRANSACTIONS FOR SELLER-LESSEES

This section discusses accounting treatment of sale and leaseback transactions involving real estate, including real estate with equipment. Sale and leaseback transactions involving real estate with equipment include any transactions in which the equipment and real estate are sold and leased as a package, irrespective of the relative value of the equipment and the real estate.

Sale and leaseback accounting is an accounting procedure whereby the seller-lessee records the sale, removes all property and related liabilities from its balance sheet, recognizes gain or loss from the sale, and classifies the leaseback as specified herein.

Sale and leaseback accounting is to be used only if a sale and leaseback transaction includes all of the following:

a) A normal leaseback transaction wherein the lessee-lessor relationship involves the active use of the leaseback property by the serer-lessee in consideration for payment of rent and excludes other continuing involvement provisions or conditions. Active use of the leaseback property means the use of the property during the lease term in the seller-lessee's business, providing that the present value of all subleasing, if any, is less than 10% of the fair value of the leaseback property.

b) Payment terms and provisions that adequately demonstrate the buyer-lessor's initial and continuing investment in the leaseback property.

c) Payment terms and provisions that transfer all of the other risks and rewards of ownership as demonstrated by the absence of any other continuing involvement by the seller-lessee. Examples of continuing involvement are that the seller-lessee has an option or obligation to repurchase the property or the buyer-lessor can compel the serer-lessee to repurchase the leaseback property, or that the seller-lessee guarantees the buyer-lessor's investment or a return on that investment.

A sale and leaseback transaction not qualifying for sale and leaseback accounting because of any form of continuing involvement by the seller-lessee (other than a normal leaseback) is to be accounted for by the deposit method or as a direct financing lease.

Credit unions should generally use the direct financing lease type of accounting in these circumstances. The deposit method of accounting is used when the uncertainty of the collectibility of the sales price is so great that the effective date of the sale is deferred until collectibility of the sale price is more reasonably assured. Given the risk and the uncertainty of this type of transaction, credit unions should generally participate in the kind of transaction that would require this type of accounting. The deposit method of accounting is discussed in section 6030.15 of this Manual.

If the terms of the sale and leaseback transaction are substantially different from terms that an independent third party would accept, then those terms represent an exchange of some stated or unstated rights or privileges. Those rights or privileges must be considered in evaluating the continuing involvement provisions stated immediately above.

The terms referred to above include, but are not limited to, the sales price, the interest rate, and other terms of any loan from the seller-lessee to the buyer-lessor. To assure that any sale and leaseback transactions meet the provisions of this section, the fair value of the leaseback property should be based on an independent third party appraisal.

There are many more examples of provisions or conditions which constitute continuing involvement than can be discussed here. Any credit unions considering entering into sale and leaseback transactions should obtain the advice of an independent accountant to assist them in determining whether the transaction qualifies as a bona fide sale and leaseback transaction.

Such credit unions should also obtain an opinion from a competent attorney concerning the legality of any such transaction before entering into it.

Considering the wide variety of sale and leaseback transactions and the effects different conditions and provisions may have on the obligations of the parties involved, it is incumbent on any credit union considering entering into such a transaction that all of the obligations for both parties be fully understood and agreed upon before finalizing such an agreement.

6080.11.1.3 FINANCIAL STATEMENT PRESENTATION AND DISCLOSURE FOR SALE AND LEASEBACK TRANSACTIONS FOR SELLER-LESSEES

In addition to the disclosures required by other sections pertaining to leases, the financial statements of a seller-lessee are to include a description of the terms of the sale and leaseback transaction, including future commitments, obligations, provisions, or circumstances that require or result in the seller-lessee's continuing involvement.

A credit union which has accounted for a sale and leaseback transaction using the deposit method or as a financing lease is to disclose:

a) The amount the credit union is obligated for future minimum lease payments as of the date of the most recent balance sheet in total, and for the next succeeding five fiscal years, and

b) The amount of minimum sublease rentals the credit union is to receive, if any, under noncancel-able subleases in total and for the next succeeding five fiscal years.

6080.11.2 ACCOUNTING TREATMENT FOR SALE AND LEASEBACK TRANSACTIONS FOR BUYER-LESSORS

Sale and leaseback transactions for all or part of the remaining life of the leaseback property for buyer-lessors are for as follows:

a) If the lease meets any one of the criteria a, b, c, or d in section 6080.10, and if it meets both the criteria e and f of the same section, the buyer-lessor is to record the transaction as a purchase and a direct financing lease.

b) If the transaction fails to meet the tests stated in the immediately preceding paragraph, then the buyer-lessor is to record the transaction as a purchase and an operating lease.

6080.12 ACCOUNTING FOR SUBLEASES AND SIMILAR TRANSACTIONS

The accounting treatment for the following types of leasing transactions are discussed below:

a) The leased property is re-leased by the original lessee to a third party, and the lease agreement between the original lessee and the lessor remains intact.

b) A new lease is substituted under the original agreement. The new lessee becomes primarily obligated, and the original lessee may or may not remain liable.

c) A new lessee is substituted through a new agreement, and the original agreement is canceled.

6080.12.1 ACCOUNTING FOR SUBLEASES AND SIMILAR TRANSACTIONS FOR THE ORIGINAL LESSOR

If the original lessee enters into a sublease or the original lease agreement is sold or transferred by the original lessee to a third party, the original lessor is to account for the lease as before.

If the original lease agreement is replaced with a new agreement with a new lessee, the lessor is to account for the termination of the lease, and account for the new lease as a new transaction.

6080.12.2 ACCOUNTING FOR SUBLEASES AND SIMILAR TRANSACTIONS FOR THE ORIGINAL LESSEE

If the credit union is not relieved of the primary obligation under the original lease, as would be the case in situation a of section 6080.12, the credit union, as original lessee and as sublessor would account for the transaction as follows.

a) The credit union will continue to account for the obligation related to the original lease as before. The credit union is to determine whether the new lease meets the criteria in section 6080.10.1. If it meets any one of criteria a, b, c, or d and both of criteria e and f, the credit union is to classify it as a sales or a direct financing lease, and the unamortized balance of the asset under the original lease is to be treated as the cost of the leased property. If the new lease does not qualify as a sales or direct financing lease, the credit union is to account for it as an operating lease.

b) The credit union as original lessee is to account for the obligation under the original lease as it did before. If the original lease met either criteria c or d of section 6080.10.1, the credit union as original lessee is to classify the new lease in accordance with the criteria a, or b, and both e and f of section 6080.10.1. If it meets those criteria, the credit union is to account for the lease as a direct financing, with the unamortized balance of the asset under the original lease treated as the cost of the leased property. If the new lease does not meet the above stated criteria, then the credit union is to account for it as an operating lease.

c) If the original lease is an operating lease, the credit union as original lessee is to account for both the original and the new leases as operating leases.

6080.12.3 ACCOUNTING FOR SUBLEASES AND SIMILAR TRANSACTIONS FOR THE NEW LESSEE

If the credit union is a new lessee, the credit union is to classify the lease in accordance with the criteria found in section 6080.1.10, and is to account for it accordingly.

6080.13 ACCOUNTING FOR LEASE CHANGES, RENEWALS, EXTENSIONS AND EARLY TERMINATIONS

Credit unions will account for changes in the provisions of a lease, renewals, extensions of existing leases, or early termination of leases as follows.

6080.13.1 ACCOUNTING FOR CHANGES TO LEASE PROVISIONS

If a credit union's lease provisions are changed in a way that changes the amount of the remaining minimum lease payments, and if the lease remains a sales-type lease or if it results in a new agreement classified as a direct financing lease, the credit union will adjust the balance of the minimum lease payments receivable and the estimated residual value downward, if affected, to reflect the change. The credit union will charge the net adjustment to unearned income. Upward adjustments of the estimated residual value are not made.

If changes in the lease provisions give rise to a new agreement classified as an operating lease, the credit union is to remove the remaining net investment from the books, and the credit union is to record the leased asset as an asset at the lowest of its original cost, present fair value, or present carrying amount. The net adjustment, if any, is to be charged to income for the current period. The credit union is to account for the new lease as an operating lease.

6080.13.2 ACCOUNTING FOR RENEWALS OF OR EXTENSIONS TO LEASE PROVISIONS

Except when a guarantee or penalty is rendered inoperative, credit unions are to account for renewals or extensions as follows:

a) If the credit union classifies the renewal or extension as a direct financing lease, it is to account for the renewal or extension the same as it would for a change, as stated in section 6080.13.l.

b) If the credit union classifies the renewal or extension as an operating lease, it is to continue to account for the existing lease as a sales-type lease to the end of its term, and then account for the renewal or extension as any other operating lease.

c) If the credit union classifies a renewal or extension that occurs at or near the end of the term of the existing as a sales-type lease, it is to account the renewal or extension as a sales-type lease.

6080.13.3 ACCOUNTING FOR EARLY TERMINATIONS OF LEASE PROVISIONS

Credit unions account for early lease terminations by removing the net investment from their books and recording the leased asset at the lowest of its original cost, present fair value, or present carrying value. The credit union will charge the net adjustment to income for the current period.

6090 MEMBERSHIP IN CENTRAL LIQUIDITY FACILITY

6090.1 PURPOSE OF THE CENTRAL LIQUIDITY FACILITY

The purpose of the Central Liquidity Facility (CLF)) is to improve the general financial stability by credit unions with a source of loans to meet liquidity needs, and thereby encourage savings, consumer and mortgage lending, and provide financial resources to all segments of the . CLF was established by Congress to provide credit unions with a source of funds such as banks and savings and loan associations have a long as available through the Federal Reserve System and the Federal Home Loan Banks.

6090.2 AVAILABILITY OF MEMBERSHIP IN THE FACILITY

Membership in the CLF is available to both federal and state-chartered credit unions. There are two types of memberships: regular membership and agent membership. A natural person credit union may become a regular member or may gain access to the CLF through an agent member. Agent membership is open only to credit unions or groups of credit unions which primarily serve other credit unions. A regular member carries on its dealings directly with the CLF whereas a credit union which gains access to the CLF through membership in a central credit union (which is an agent member) would deal only with the agent member and not directly with the CLF. Part 725 of the National Credit Union Administration Rules and Regulations provides procedures that must be followed in order to become either a regular or agent member.

If an agent is federally chartered, it can require a member natural person credit union to establish and maintain a special share account. This account will reimburse the agent for the portion of the agent's stock subscription which is attributable to each natural person credit union. The special share account maintained in the CLF by a natural person credit union does not qualify as an investment in the CLF. Part 725 of the NCUA Rules and Regulations states that member natural person credit unions are not members of the CLF unless they are also regular members of the CLF.

6090.3 REQUIRED STOCK SUBSCRIPTION

In order to become a regular member of the CLF, a credit union must subscribe to stock in a total amount of one-half of one percent of the credit union's 6 paid-in and unimpaired capital and surplus." Only one-half of the required stock subscription must be paid to the CLF while the other one-half of the subscription will be on call by the NCUA Board and must be invested in liquid assets.

Agent members must also subscribe to the capital stock of the CLF. The amount of the subscription is one-half of one percent of the paid-in and unimpaired capital and surplus of all the natural person credit unions which are members of the applicant central credit union, or in the case of a group of central credit unions which are members of any central credit union in the group. As in the case of regular members, only one-half of the required stock subscription must be paid to the CLF, while the remainder will be on call by the National Credit. Union Administration Board and must be invested in liquid assets.

The required subscription will be adjusted annually to reflect changes in the paid-in and unimpaired capital and surplus upon which the stock subscription is based.

6090.4 COMPUTING THE AMOUNT OF THE STOCK SUBSCRIPTION

Paid-in and unimpaired capital and surplus is defined as the balances of the paid-in share accounts and deposits as of a given date, less any loss that may have been incurred for which there is no reserve or which has not been charged against Undivided Earnings, plus the credit balance (or less the debit balance) of the Undivided Earnings, after all losses have been provided for and net earnings have been added or net losses deducted. In most cases, paid-in and unimpaired capital and surplus can be determined simply by totaling shares (including all share certificates, share draft accounts, split rate accounts, mini m balance accounts, etc.), Undivided Earnings (including all discretionary reserves such as reserve for contingencies, investment reserves (SCUs only), or other appropriated reserves, etc.), and net income to date (or less net loss to date). The total obtained will be reduced in those relatively rare cases of unusual losses which have not yet been recognized on the federal credit union's records, e.g., a lawsuit against the credit union in which it has been adjudged that the credit union is at fault and must pay a penalty of $1,000 or more at a later date.

The initial stock subscription is based on an arithmetic average of paid-in and unimpaired capital and surplus over the six months preceding the application for membership and is adjusted at the close of each calendar year in accordance with the arithmetic average of paid-in and unimpaired capital and surplus over the 12 months in such calendar year.

As an example computation of an initial stock subscription, assume that XYZ Credit Union applies for a regular membership in October. The computation of the 6-month arithmetic average of paid-in and unimpaired capital and surplus and General Ledger balances of applicable accounts would be as follows:

(1) Month	(2) Shares	(3) (State Credit Unions only) Deposits	(4) Undivided Earnings	(5) Net Gain or (Loss)	(6) Unimpaired Capital & Surplus
(a) 09/30/80	$512,000	$500,000	$9,800	$22,200	$1,044,000
(b) 03/31/80	501,000	499,000	6,000	14,000	1,020,000
(c) Total					$2,064,000

Line (a) should have information as of the most recent month end prior to the date of application. Line (b) should have the information as of 6 months ends prior to the month end preceding the date of application.

Assuming there are no unrecognized losses, the totals for line (a) and line (b) are added together and divided by two, giving an average paid-in and unimpaired capital and surplus of $1,032,000. The required stock subscription will then be computed by taking one-half of 1 percent of that figure, or $5,160. One-half of that amount will be forwarded to the CLF and the remainder will be invested in liquid assets.

6090.5 ACCOUNTING ENTRIES FOR CLF TRANSACTIONS MEMBERSHIP AND DIVIDENDS

Funds invested in stock of the CLF should be recorded as a debit to “Investment in CLF - Membership Stock,” (Account No. 751.1). Dividends will be paid on CLF stock at least annually as determined by the NCUA Board. The on-call portion of the subscription should not be included in Account No. 751 unless it is actually invested in the CLF.

Dividends on capital stock will be paid by crediting the members’ capital stock accounts. Therefore, “Investment in CLF,” (Account No. 751.1) should be debited and “Income from Investments,” (Account No. 121) should be credited whenever the credit union receives notice of the amount of the dividend credited to its account. Dividends received on the CLF investment are excludable from gross income in computing the amount of the statutory transfer to the Regular Reserve at the end of each accounting period.

6090.6 EXTENSION OF CREDIT TO MEMBERS

The CLF is authorized to make loans to meet liquidity needs, and is specifically prohibited by statute from making any loan “the intent of which is to expand credit union loan portfolios.” Regular members should submit their applications for credit directly to a CLF lending officer at a designated location. Credit unions which access the CLF through an agent member should submit their applications for credit directly to a CLF lending officer at a designated location. Credit unions which access the CLF through an agent member should submit their applications to the agent, which can then make the loan out of its own funds or immediately apply to the CLF for funds to make the loan. In any case, when the requesting credit union receives the funds, the accounting is the same as for funds borrowed from any other source.

For example:

Dr. - Cash (Acct. No. 731)	$50,000	
Cr.-Notes Payable - Other (Acct. No. 812)		$50,000

Interest on the borrowed funds should be charged to “Interest on Borrowed Money,” (Account No. 340).

6090.7 ILLUSTRATIVE ENTRIES

a) Natural Person Credit Union

Upon subscription to the CLF as a Regular member and payment of the required 1/4 of 1 % of unimpaired capital and surplus the natural person credit union would make the following entry on its books:

Dr. - Investment in CLF- Membership Stock (Acct. No. 751.1)	$XXXXXX	
Cr.-Cash (Acct. No. 731)		$XXXXXX

If the credit union purchases CLF stock in addition to its required portion, the entry would be as follows:

Dr. - Investment in CLF-
Liquidity & Clearing
(Acct. No. 751.2) .... $YYYY
Cr.-Cash (Acct. No. 731) ....$YYYY

If the credit union has a liquidity-clearing account as well as a membership-stock account in the CLF, and reports these two accounts as a single line item on its financial statements, the following note could be used:

> "The investment in Central Liquidity Facility includes $XXXX which is required for membership in the CLF to make the credit union eligible to receive loans or other assistance from the CLF to meet liquidity needs. This stock may be redeemed only by withdrawing from membership in the CLF. A like amount is required to be held on-call in certain prescribed liquid assets. The balance ($YYYY) represents a discretionary investment in the CLF and may be redeemed at any time. The membership stock and the discretionary investment may not be pledged or hypothecated except to the CLF."

b) Corporate Central Credit Union

Upon subscription to CLF stock, acceptance by the Board as an Agent member and payment of the required 1/4 of 1% of the unimpaired capital and surplus of all its member credit unions which are not Regular members of the CLF, the corporate central would make the following entry on its books:

Dr. - Investment in CLF-
Membership Stock
(Acct. No. 751.1) .... $XXXX
Cr.-Cash (Acct. No. 731) .... $XXXX

If the credit union purchases CLF stock in addition to its required portion, the entry would be as follows:

Dr. - Investment in CLF-
Liquidity & Clearing
(Acct. No. 751.2) .... $YYYY
Cr.-Cash (Acct. No. 731) .... $YYYY

On its financial statements the credit union may show the membership-stock portion and the liquidity-clearing portion separately or in a lump sum. Whichever method is used, a note is required to describe the nature of the investment and to disclose the on-call portion of the stock subscription.

If the corporate central has a liquidity-clearing account as well as a membership-stock account in the CLF, and reports these two accounts as a single line item on its financial statements, the following footnote could be used:

> "The investment in the Central Liquidity Facility includes $XXXX which is required for Agent membership in the CLF. Agent membership permits this corporate central to obtain loans from the CLF to meet the liquidity needs of member credit unions. This stock may be redeemed only by withdrawing from membership in the CLF. A like amount is required to be held on-call (by the NCUA Board) in certain prescribed liquidity assets. The balance ($YYYY) represents a discretionary investment in the CLF and may be redeemed at any time. The membership stock account and the liquidity reserve and clearing account may not be pledged or hypothecated except to the facility.

6110 CREDIT UNION SERVICE ORGANIZATIONS

Section 107(5)(D) of the Federal Credit Union Act defines a credit union service organization as any organization, as determined by the National Credit Union Administration Board, which is established primarily to serve the needs of its member credit unions, and whose business relates to the daily operations of the credit unions they serve.

Sections 107(7)(1) and (107(5)(D) of the Federal Credit Union Act authorizes federal credit unions to invest in and make loans to credit union service organizations (CUSOs). Part 701.27 of the National Credit Union Administration Rules and Regulations implements these sections by addressing various issues, including monetary limits on loans and investments, the structure of credit union service organizations, their customer base, and the range of services and activities that they may provide. The regulation also establishes standards for federal credit union involvement with CUSOs through provisions concerning conflict of interest, accounting practices, and NCUA access to books and records. The regulations also state that a federal credit union must obtain written legal advice as to whether the CUSO is established in a manner that will limit the credit union's exposure to no more than the loss of funds invested in or lent to the CUSO. Management's of credit unions which have CUSOs, or are considering establishing a CUSO, should be fully aware of and comply with Section 701.27 of the NCUA Rules and Regulations.

6110.1 ACCOUNTING PROCEDURES

The regulation cited above requires that a federal credit union follow generally accepted accounting principles (GAAP) in its involvement with CUSOs. In addition, a credit union must obtain written agreements from a CUSO, prior to investing in or lending to the organization, that the organization will:

a) Follow GAAP;

b) Render financial statements (balance sheets and income statements) at least quarterly, obtain an annual audit performed by a certified public accountant and provide copies of the same to the affiliated federal credit union; and

c) Provide the NCUA Board or its representatives with complete access to any books and records of the CUSO as deemed necessary by the NCUA Board in carrying out its responsibilities under the Federal Credit Union Act.

6110.1.1 INVESTMENTS IN AND LOANS TO CREDIT UNION SERVICE ORGANIZATIONS

Section 701.27(d)(1) of the National Credit Union Administration Rules and Regulations provides that a federal credit union may invest in shares, stocks or obligations of CUSOs in amounts not exceeding, in the aggregate, 1 percent of the credit union's paid in and unimpaired capital and surplus (total of all shares and undivided earnings plus net income or minus net losses to date) as of its last calendar year-end financial report. This same section authorizes credit unions to make loans to CUSOs in amounts not exceeding, in the aggregate, I percent of its paid in and unimpaired capital and surplus as of its last calendar year-end financial report.

For purposes of measuring a CU's investments and loans to a CUSO in financial statements, GAAP should be followed. GAAP requires one of three measurement options (cost method, equity method, or consolidated financial statements) depending on the degree of ownership a CU has in a CUSO (See Section 6110.3 for a further discussion). However for purposes of statutorily derived limitations in the CUSO rule, the CU's "aggregate cash outlay" should be used.

As an example for computing the maximum amount which may be invested in a CUSO, assume that a federal credit union shows the following applicable General Ledger account balances, and assume that there are no losses which have not been provided for:

Total of all Saving Accounts	$5,000,000
Undivided Earnings	250,000
Net Income to Date	20,000
Total Unimpaired Capital and Surplus	$5,270,000

The investment limit, aggregate cash outlay, would then be 1 percent of $5,270,000 or $52,700. The credit union could lend an additional $52,700 to the CUSO. A federal credit union need not invest in a CUSO before it can lend to it.

6110.2 ACCOUNTING ENTRIES

6110.2.1 EQUITY METHOD

When a credit union invests in the outstanding voting stock of a CUSO and has the ability to exercise significant influence over the management of the CUSO, the equity method of accounting for investments should be used. *(Note:* It is generally presumed that an investment of 20 percent or more of the voting stock of a CUSO indicates the ability to exercise significant influence.)

Using the equity method, the investing credit union would record the initial investment at cost. During subsequent accounting periods, the credit union would adjust the investment account balance for its proportionate share of the CUSO's net income or loss. Dividends paid by the CUSO in cash should be treated and recorded by the credit union as a conversion of the investment into cash causing the investment amount to decrease.

Illustrative Entries:

To illustrate the equity method, assume that ABC Federal Credit Union purchases 40 percent of the voting common stock of Zebra Credit Union Service Corporation for $500,000 which corresponds to the underlying value of the corporation. During the subsequent period, Zebra reported net income of $100,000 (including a $50,000 extraordinary gain) and paid a dividend of $50,000. ABC Federal Credit Union would account for its investment as follows:

Entry #1-To record the acquisition of 40 percent of the common stock of Zebra Credit Union Service Corporation at carrying value.

Dr. - Investment in Credit Union Service Corporation (Acct. No. 748)	$500,000	
Cr.-Cash (Acct. No. 731)		$500,000

Entry #2-To record 40 percent net income of Zebra Credit Union Service Corporation (40% x operating gain of $50,000 = $20,000; and 40% x nonoperating gain of $50,000 = $20,000).

Dr. - Investment in Credit Union Service Corporation (Acct. No. 748)	$40,000	
Cr.-Income from Investments in Credit Union Service Corporation (Acct. No. 128.1)		$20,000
Cr.-Gain (Loss) on Investments (Acct. No. 420)		20,000

Entry #3-To record dividends received from Zebra Credit Union Service Corporation (40% x $50,000 = $20,000).

Dr. - Cash (Acct. No. 731) $20,000
Cr.-Investment in Credit
Union Service Corporation
(Acct. No. 748) $20,000

In this example, it should be noted that the net effect of ABC Federal Credit Union's accounting for Zebra Credit Union Service Corporation's net income and dividends was to increase the investment account by $20,000. This corresponds to 40 percent of the increase reported in Zebra Credit Union Service Corporation's net assets during the period (40% x ($100,000 - $50,000) = $20,000).

Assume that in the following year the credit union service corporation has a $100,000 operating loss. The credit union would record its proportionate share of this loss as follows:

Entry #4-To record the 40 percent net loss of Zebra Credit Union Service Corporation (40% x $100,000 = $40,000).

Dr. - Income from Investments in
Credit Union
Service Corporation
(Acct. No. 128.1) $40,000
Cr.-Investment in Credit
Union Service Corporation
(Acct. No. 748) $40,000

If an investment in voting stock falls below the 20 percent level, the presumption is that the credit union has lost the ability to exercise significant influence in which case the equity method should be discontinued. The carrying amount at the date of discontinuance becomes the cost of the investment. Subsequently, dividends are accounted for by the cost method from the date the equity method was discontinued.

6110.2.1.1 SPECIAL ACCOUNTING TREATMENT

Under the equity method various transactions require special accounting treatment such as the elimination of intercompany profits and losses until they are realized by the investing credit union or the credit union service corporation. In addition, when the acquisition cost of an investment differs from the carrying value of the underlying net assets of the credit union service corporation, adjustments may have to be made to the investment income of the investing federal credit union.

6110.2.1.2 COST IN EXCESS OF CARRYING VALUE

A credit union may pay more for its investment than the underlying carrying value of the CUSO's assets. This is because the fair value of the CUSO's assets is more than their recorded amounts, or because the CUSO has unrecorded goodwill. In either instance, the cost in excess of the carrying value will only benefit the investing federal credit union over the useful lives of the overvalued or unrecorded assets.

The excess of the cost over the carrying value incurred in acquiring a credit union's investment in a CUSO should be amortized over the economic lives of the assets by recording the following entry:

Dr. - Income from Investments in
Credit Union
Service Corporation
(Acct. No. 128.1) XX
Cr.-Investment in Credit
Union Service Corporation
(Acct. No. 748.0) XX

Where the excess cost was incurred due to implied goodwill, the amount of the excess should be amortized over the estimated economic life of that goodwill, which will not be a period in excess of 40 years.

6110.2.1.3 COST LESS THAN CARRYING VALUE

If the carrying value of the underlying assets of the credit union service corporation is in excess of the credit union's acquisition costs, it is assumed that the assets of the credit union service corporation are overvalued. The excess should be amortized, over the economic lives of the assets provided that the credit union service corporation's assets are depreciable. The accounting entry would be the opposite of the previously illustrated entry. This will result in increases in the income received from the credit union service corporation.

6110.2.2 COST METHOD

A different accounting treatment is provided in the situation where the investing credit union does not exert significant influence or exercise a controlling financial interest as a result of its investment in the CUSO. In this situation (generally assumed if the investing credit union owns less than 20 percent of the CUSO's voting common stock), the cost method of accounting should be used.

Under the cost method, the investment is maintained in terms of the cost of shares acquired. Dividends received from the current earnings of the CUSO are recognized as income, and do not affect the balance in the investment account. If, at a later date, a credit union exerts significant influence over the CUSO's operations or acquires more than 20 percent ownership in a CUSO's voting common stock, the credit union must retroactively adjust its accounts to the equity method on the basis of a step by-step acquisition of the CUSO. In this event, at the date of each step (date of each purchase of stock) the carrying value of the investment must be compared with the underlying net assets of the CUSO to determine whether goodwill is involved.

Illustrative Entries:

To illustrate the cost method, assume that a federal credit union acquires 15 percent of Zebra Credit Union Service Corporation's voting stock for $45,000. During the year, the CUSO had net income of $30,000 and paid a $3,000 dividend to the credit union. The credit union would account for its investment as follows:

Entry #1 -To record the acquisition of 15 percent of the common stock of Zebra Credit Union Service Corporation.

Dr. - Investment in Credit Union Service Corporation (Acct. No. 748)	$45,000	
Cr.-Cash (Acct. No. 731)		$45,000

Entry #2-To record dividends received from Zebra Credit Union Service Corporation.

Dr. - Cash (Acct. No. 731)	$3,000	
Cr.-Income from Investments in Credit Union Service Corporation (Acct. No. 128.1)		$3,000

The credit union's investment account at the end of the year will show a balance of $45,000, the amount of the original investment. Changes in the carrying value of the underlying assets of the CUSO are ignored unless a significant and permanent impairment of the value of the investment occurs.

Three events which may result in a departure from the cost basis would be:

a) The receipt of a liquidating dividend from a CUSO which would result in a reduction of the investment account.

b) A permanent impairment in the value of the investment and the credit union's discontinued use of the services of the CUSO. Operating losses that substantially reduce the CUSO's net assets and which seriously impair its future operations are recognized as realized losses by debiting the "Gain (Loss) on Investments," (Account No. 420) and crediting the "Investment in Credit Union Service Corporation," (Account No. 748).

c) A permanent impairment 'n the value of the investment and the credit union's continued use of the services of the corporation. The unrealized loss in value of the long-term securities should be shown as a reduction in equity. This is accomplished by establishing a valuation allowance account. When the long-term investment is sold at a price below cost, a realized loss is recorded and the unrealized loss and the established allowance account are eliminated.

6110.2.2.1 PERMANENT IMPAIRMENT AND SERVICES OF CREDIT UNION SERVICES CORPORATION ARE NO LONGER USED

To record a significant and permanent decline in value of a long-term investment in a CUSO the following entry is used.

Dr. - Gain (Loss) on Investment
(Acct. No. 420) XX
Cr.-Investment in
Credit Union Service Corporation
(Acct. No. 748) XX

Operating losses of the CUSO, which reduce its net assets substantially and which seriously impair its future prospects, should be recognized as losses. In determining whether a permanent impairment in the value of a long-term investment exists, the following facts must be considered:

a) The length of time the security has been owned;

b) The length of time the security has been below cost and the extent of the decline;

c) The financial condition and prospects of the CUSO;

d) The financial condition of the credit union; and

e) The materiality of the decline in value of the investment in relationship to the net income and equity of the credit union.

6110.2.2.2 PERMANENT IMPAIRMENT AND SERVICES OF CREDIT UNION SERVICE CORPORATION ARE BEING USED

Using the utility concept (investing in a CUSO to obtain low cost and efficient services), a credit union that is still using the services of the CUSO would not have to immediately expense the loss from the permanent decline in value of its investment. With respect to a permanent decline, the reasoning is that the credit union is deriving benefit from the credit union service corporation and therefore, cannot affix a poor prospect status upon its investment in that corporation. Assuming that the credit union has a satisfactory financial condition, that the loss would not be material, and that its investment has utility, it would seem that these reasons would outweigh any argument for writing down the investment as a charge to the income statement.

When a credit union that is on a cost basis of accounting for a long-term investment is still using the services of the CUSO and does not write down its investment to the value of the asset, it should record the unrealized losses. These unrealized losses should be recorded as a reduction of equity rather than a reduction of net income. The reduced value of the credit union's investment can be determined by the credit union's appraisal of the underlying value of the CUSO's net assets based on its year-end or periodic financial statements.

6110.3 FINANCIAL STATEMENT PRESENTATION

The presentation of the investment in a CUSO on the credit union's financial statements depends upon the amount of voting stock of the CUSO that is owned by the credit union. Therefore, the investment will be shown in one of three ways:

a) If the credit union owns over 50 percent of the voting stock of the CUSO, under generally accepted accounting principles, the credit union is deemed to have a controlling financial interest in the CUSO's operations and is required to prepare consolidated CU/CUSO financial statements. The preparation of consolidated financial statements is facilitated by using a consolidated statement working paper. An illustrative example of a consolidated statement working paper, along with examples of the elimination of intercompany transactions is presented later in this section.

b) If the credit union owns 20 to 50 percent of the voting stock of a CUSO and has the ability to exercise significant influence over its operations, the investment should be shown on the balance sheet using the equity method, i.e., as a single amount with the proportionate share of income or loss shown on the income statement as a single amount except for extraordinary items which should be shown separately.

c) If the credit union owns less than 20 percent of the voting stock of the CUSO, and therefore, has neither a controlling financial interest nor the ability to exercise significant influence over the CUSO's operation, the investment should be shown as a single amount on the balance sheet in Account No. 748.l.

Illustrative Example for Consolidated Statement Working Paper.

The following example represents credit union X's and CUSO Y's consolidated financial statements as of December 31, 1986, 1 year following credit union X's 100 percent purchase of CUSO Y's voting stock for $90,000. The par value of the stock was $75,000, undivided earnings purchased totaled $12,000, and the credit union paid $3,000 in excess of book value for the CUSO's assets.

Since the credit union purchased a controlling financial interest in the CUSO, consolidation of CU and CUSO financial statements is necessary/ required. Assume that no dividends were declared by the CUSO and that the CUSO's net income for the year was $10,000. The following entry would be made on the credit union's books to record the amount of the net income (100% interest):

Dr. - Investment in Credit Union
Service Organization
(Acct. No. 749.1) $10,000
Cr.-Income from Investments in
Credit Union Service Corporation
(Acct. No. 128.1) $10,000

Since the above entry is considered to be an "intercompany transaction," an eliminating entry on the consolidated statement working paper will be needed. These entries are necessary to prevent assets and liabilities from being overstated on the consolidated financial statement.

Other types of intercompany transactions that must be eliminated in the preparation of consolidated statements but which are not demonstrated in this example include:

a) Money loaned to a CUSO that results in an account payable on the books of the CUSO, and an account receivable on the books of the credit union.

b) Any portion of an employee's salary of the credit union that also provides services to the CUSO, that results in an accrued expense on the CUSO's books and accrued income on the credit union's books.

These examples are not intended to be an all inclusive list of necessary intercompany transactions. Because of the complicated nature of consolidated accounting, a credit union should consider the need for the services of a public accounting firm to assist in the preparation of consolidated statements.

Credit Union X and Subsidiary CUSO Consolidated Statement Working Paper
For Year Ended December 31, 1992

	Credit Union U	CUSO Y	Eliminations Debit	Eliminations Credit	Consolidated
	($000s)	($000s)	($000s)	($000s)	($000s)
Income Statement:					
Loan Income	18				18
CUSO Income	10		a) 10		
Investment Income	9				9
Other Income	3				3
Locate Fees		75			75
Auto Sales		26			26
Interest Income		11			11
Advertising		6			6
Tax Service		4			4
Total Credits	40	122	10	—	152
Salaries & Benefits	15	57			72
Total Other Op. Exp.	12	55			67
Prov for Loan Losses	5				5
Total Debits	32	112	—	—	144
Net Income, Carried Forward	8	10	10		8
Balance Sheet:					
Loans, Net	87,000				87,000
Cash	2,700	8			2,708
Investments	24,000	20			24,020
Investment in CUSO	100			a) 10 b) 90	

Credit Union X and Subsidiary CUSO Consolidated Statement Working Paper
For Year Ended December 31, 1992 (Continued)

	Credit Union U	CUSO Y	Eliminations		Consolidated
			Debit	Credit	
	($000s)	($000s)	($000s)	($000s)	($000s)
Accts Receivable		12			5,112
Notes Receivable		3			3
Other Assets	7,860	54			7,914
Differential			b) 33		3
	$126,760	$97	$343	$100	$126,760
Accounts Payable	5,000				5,500
Other Liabilities	6,002				6,002
Shares					
CU X	110,000				110,000
CUSO Y		75	b) 75		
Regular Reserve	2,350				2,350
Undivided Earnings	2,900	12	b) 12		2,900
Net Income, Brought Forward	8	10	10		8
	$126,760	$97	$97	—	$126,760

Explanation of Eliminations:

a) To reverse credit union X's proportionate share of CUSO Y's net income.

b) To eliminate the January 1, 1986, investment account balance against the corresponding equity accounts of subsidiary CUSO Y.

6110.4 LOANS TO A CREDIT UNION SERVICE ORGANIZATION

When a credit union makes a loan to a CUSO, it should follow the same procedures that would be used in the granting of a commercial loan to a member. These procedures are outlined in Section 701.21(h) of the NCUA Rules and Regulations. Particular attention should be paid to the following areas:

a) Perform an analysis of the CUSO's ability to meet the payment schedule shown on the Promissory Note. This would include an in-depth cash flow analysis.

b) Collateral requirements, including loan to value ratio's; appraisal, and title searches; steps to be taken to secure various types of collateral, and how often the value and marketability of collateral is to be reevaluated, along with frequency of on-site inspections of the collateral.

c) Appropriate interest rates and maturities of the loan(s).

d) Loan monitoring and follow-up procedures.

If the CUSO is not able to make payments on **a** regular basis, causing the loan to become delinquent, the loan should be treated as any other delinquent loan. This would include listing the loan on the monthly delinquent loan report, and reserving for any possible losses on the loan if the loan becomes seriously delinquent. Generally accepted accounting principles requires a credit union to establish **a** reasonable amount in the Allowance for Loan Losses Account to cover estimated losses inherent in the loan.

6110.4.1 ACCOUNTING PROCEDURES

The accounting entries for a loan to a CUSO should be the same as those for a loan to a member except that Account No. 748.2, "Loans to a Credit Union Service Organization," should be used rather than Account No. 701. Refer to Section 4050.4 in the Accounting Manual.

6110.4.2 COLLECTION PROCEDURES

The collection procedures for a loan to a CUSO should be essentially the same as for a loan to **any** member. Refer to Section 5220.2.8 in this Accounting Manual for a discussion on establishing and maintaining an effective collection program.

6120 SPECIAL ACCOUNTING AND OPERATING PROCEDURES FOR FEDERAL CREDIT UNIONS MAINTAINING BRANCH OPERATIONS

A branch operation can be established for a variety of reasons or circumstances. Some branches are established to extend services within an existing field of membership, or are the result of mergers with other credit unions. Sometimes a branch is established due to the expansion of the sponsor or to better serve membership at distant geographical locations. If a federal credit union has one or more branch offices, a review of the branches' operations should be performed on a periodic basis. This review should include at least the following: cost effectiveness, adequacy of internal controls, and service to members.

When assessing the areas of services to members and cost effectiveness, the board of directors need to determine the effect of a branch operation on shares, loans, income, expenses and reserves. This same analysis would be applied whenever a federal credit union adds one or more branches, or desires to establish its first branch operation.

Whenever a credit union increases the number of branch offices or establishes its first branch, the board of directors need to consider the effect these actions will have on the amount of fixed assets owned or leased by the credit union. This is necessary because Section 701.36 of the National Credit Union Administration Rules and Regulations places some limitations on the amount that can be invested in fixed assets. Section 6070 in this Accounting Manual provides a detailed explanation of the limitations.

In summary, establishing a branch operation, maintaining existing branch operations, or establishing branch offices requires thorough planning by the board of directors.

6120.1 BRANCHES

Management must determine the type of branch office control to establish. The decision is based upon policy, available staff, member needs and the nature of the recordkeeping system and equipment available. The degree of control can vary from centralized, where strict control is maintained in the main office, to decentralized, where the branch operates under a maximum of main office direction. Under either type of control the scope of operations can vary from form processing such as member and loan applications, to full service such as cash receipt and disbursements, and loan application approval and disbursements.

6120.2 CENTRALIZED OPERATIONS

This type of control requires maintenance of the books of account, including the member's ledgers and all other essential records, in the main office. In order to retain proper control of transaction activity in central operations, effective communication must be established between the branch and the main office. Immediate availability of communication is essential if the branch has the function of disbursing funds to members. For example, in the case of a share withdrawal, an inquiry must be made to the main office to determine if sufficient unencumbered shares are available for withdrawal. Communication can be established and maintained by any one or combination of methods such as by special messengers, couriers, mail telephone, data transmission by electronic means, teller terminals, etc.

Regardless of the type of communication used, procedures must be established to insure that the information exchanged between the main office and the branch is both current and accurate.

For centralized operations, an accounting system needs to be developed that will identify the share and loan accounts initiated and maintained at or by the branch, and create separate income and expense accounts for the branch by adding a suffix to the primary account, e.g., Account No. 111-1, "Interest on Loans-Branch No. l," etc.

The accounting and operating procedures discussed herein encompass a wide range of services. Variations of the procedures can be adapted to suit the degree and complexity of the services offered.

6120.2.1 CASH RECEIPTS

Cash receipts can be received from over the counter share deposits and loan payments, purchase of travelers checks and money orders, etc. To record cash receipts at the branch office, three copies of the cash received voucher are usually prepared. One copy of the voucher is transmitted to the main office, another is filed at the branch office and a third copy is given to the member as a receipt. Additional copies may be needed if source documents are batched and sent to an electronic data processor.

Cash receipts are balanced daffy. An original and one copy of the summary voucher is prepared. One copy is included with the cash received vouchers being sent to the main office while the other copy is retained at the branch. With an on-line system, the process can be combined whereby the cash received voucher is a by-product of data entry into the terminal. If information is transmitted by hard copy, as well as by computer, both sources must be reconciled.

6120.2.2 DISBURSEMENTS

All branch office disbursements must be supported by vouchers. The original vouchers along with the summary are to be sent to the main office. The duplicate vouchers, along with the duplicate of the summary, are to be held at the branch office.

6120.2.3 CASH ACCOUNTS

Several types of cash accounts may be established if receipts and disbursements are processed through the branch office:

a) Change fund-this must be authorized by board policy and would depend upon the volume of transactions, proximity to the main office and facilities for handling cash.

b) Checking account-this could either be a separate account in the same bank as the main office, or an account in a bank located within the same city as the branch office. Arrangements can be made in advance for transfer of funds as necessary. The bank statements and canceled checks should be sent to the main office for reconcilement.

6120.2.4 PROCESSING OF LOANS

Loans may be disbursed at the branch office after approval by a loan officer pursuant to the authority delegated by the credit committee or board of directors. Applications which require credit committee action must be referred to the committee at the main office for approval or disapproval. After action has been taken on these items, approval and rejection advices should be sent to the branch office on a flow basis.

Loan documents are usually transmitted to the main office; however the board of directors may decide that these documents be maintained at the branch office. If the loan documents are sent to the main office, sufficient information to meet member servicing needs should be maintained at the branch office.

6120.2.5 RECORDS AT A BRANCH

Although the books of account and essential records are usually maintained in the main office, it is necessary for the branch to maintain some records so that day-to-day operations may be conducted with the members as follows:

a) Duplicate of cash received, cash disbursed, journal and summary vouchers;

b) Duplicate records affecting payroll deductions;

c) Duplicate membership applications cards or some other means of identifying members;

d) Duplicate of the Individual Share and Loan Ledgers; and

e) A daily log for Cash, Shares and Loans. This record is useful in determining cash needs on a daily basis. At the end of each month, the cumulative totals of the daily log are determined.

6120.2.6 STAFFING OF A BRANCH

The board of directors must provide necessary operating staff for the branch office including the appointment of one or more assistant treasurers or assistant managers. The credit committee or the board of directors, if the bylaws so provide, may want to appoint one or more loan officers. The loan officer may serve as an assistant manager or assistant treasurer. However, the restrictions against disbursing proceeds of a loan which are approved by the same person, must be observed. If the branch office and main office are in proximity of each other, rotation of personnel may be appropriate.

6120.2.7 SURETY BOND AND OTHER INSURANCE COVERAGE

Coverage under the surety bond and other insurance policies may not automatically extend to the branch office. The board of directors will need to determine that surety coverage is provided in accordance with Section 701.20 of the National Credit Union Administration Rules and Regulations. The need for and extent of coverage provided by other types of insurance should also be determined by the board of directors.

6120.2.8 SUPERVISORY COMMITTEE

Provisions must be made to include the operations of the branch office in the comprehensive annual audit performed each year and the verification of members' accounts. Surprise cash counts, bank (checking) account reconciliations, and inventories of money orders and travelers checks should be included in the audit steps.

6120.2.9 MEMBERSHIP APPLICATIONS

Membership officers may be appointed by the board of directors for branch offices as required. Persons appointed must be members of the credit union and other than persons authorized to disburse funds or to serve as loan officers.

6120.2.10 SECURITY

Provision must be made for compliance with Section 748 of the National Credit Union Administration Rules and Regulations (Minimum Security Devices and Procedures) at each branch location.

6120.2.11 RECORDS PRESERVATION

As a minimum, duplicate records need to be retained at the branch office until the transactions reflected on them have been recorded and balanced at the main office. In setting a destruction schedule, the board of directors will need to consider the value of the duplicate records as a tool for answering questions presented by the members as well as the needs of the supervisory committee in auditing the branch office.

6120.2.12 SERVICE

There are occasions where branch office members may appear at the main office for service and vice versa. Careful separation of account activity between members at the branch office versus members at the main office is a crucial aspect of branch office control, e.g., using a special suffix, code, or block of account numbers to identify branch office members.

6120.2.13 OVERSEAS BRANCHES

Most of the procedures indicated above for a centralized operation also apply to the establishment and operation of overseas branches for stateside credit unions which provide immediate communication to the branches via teletype, telex or similar data transmission system. Stateside credit unions that do not provide immediate communication to overseas branches operate under a modified centralized/decentralized operation which mandate special approaches and procedures described in Section 6125 of this manual.

6120.3 DECENTRALIZED OPERATIONS

Under this type of control the branch management operates under a minimum of main office direction and is responsible to the main office. In practice, the board of directors may select any type of control between the two extremes. To illustrate decentralized operations, it will be assumed that the branch is a “mini” credit union, operating within board policy. Monthly financial statements are prepared and submitted to the board of directors. Separate Individual Share and Loan Ledgers, a Journal and Cash Record and a General Ledger are maintained by the branch office. In a decentralized operation, boards of directors should develop an operating budget for the branch office and conduct periodic reviews of the budget by comparing actual income and expense amounts to budgeted amounts.

6120.4 ACCOUNTING SYSTEM FOR A BRANCH

As stated previously, the extent of the accounting activity at a branch depends on credit union policy. The operating policies of one credit union may require a complete set of accounting records at each branch; policies at another credit union may call for the concentration of all accounting records in the main office.

In some credit unions, the branch maintains a complete set of accounting records. They consist of the Journal and Cash Record, the General Ledger, Expense Ledgers, a Chart of Accounts, and segregated Individual Share and Loan Ledgers; all similar to those of an independent credit union. The branch also prepares monthly financial statements and forwards them to the main office. The main office thus establishes the number and types of General Ledger Accounts, internal control policies and procedures, the form and content of financial statements, and the accounting policies.

The range of transactions that need to be accounted for by a branch are those transactions which consist of controllable expenses and income for which the branch manager is responsible. If the branch manager has responsibility for all assets of the branch and its expenditures, the branch accounts need to reflect this responsibility. Expenses that are not within control of the branch should be accounted for by the main office. These expenses are then allocated and charged to the branch in accordance with management's allocation policy. The branch's Statement of Income (FCU 109B) will then reflect those charges.

6120.4.1 RECIPROCAL ACCOUNTS

The accounting records maintained by a branch should include a main office account (Account No. 865) which is credited for all purchases, cash, or other funds provided by the main office. It should be debited for all cash, purchases, or other funds sent by the branch to the main office or other branches.

The "Main Office Account" is shown in the liability section of the branch's Statement of Financial Condition (FCU 109A). This account shows the main office's net investment in the branch. At the end of the accounting period when the branch closes its accounts, the "Net Income (Loss)-Branch #1," (e.g., Account No. 960-1), would be closed to the main office's "Net Income Account," (Account No. 960). The account balance would either increase when there was net income or decrease when there was a net loss.

6120.4.2 INVESTMENT IN BRANCH ACCOUNT

As for the accounting records of the main office, a reciprocal account is maintained, titled, "Investment in Branch," (Account No. 753). The account is debited for the cash, purchases, and services that are provided to the branch and the net income earned by it. It is credited for the cash or assets that are received from the branch office and for any net loss incurred by the branch.

6120.5 FINANCIAL STATEMENTS FOR THE BRANCH

The branch needs to prepare a separate Statement of Financial Condition (FCU 109A) and a Statement of Income (FCU 109B). The only different aspect of a Statement of Financial Condition (FCU 109A) for a branch is the use of the Main Office Account (Account No. 865) instead of the investment accounts used by the main office.

6120.6 FINANCIAL STATEMENTS FOR THE MAIN OFFICE AND THE BRANCH

The Statement of Financial Condition (FCU 109A) that is made available to credit unions members or posted in the credit union's main office must show the financial position of the credit union as a single unit. A working paper would normally be prepared reflecting the adjusted trial balances of the home office and the branch. The Statements of Financial Condition (FCU 109A) and the Statements of Income (FCU 109B) would be used for this purpose. **Figure 6-XX** provides an illustration of such a working paper.

In completing the working paper, the assets and liabilities of the branch are substituted for the "Investment in Branch" account (Account No. 753) shown on the workpaper as part of the main office's trial balance. This is accomplished by the combination eliminating entries whereby:

a) The "Main Office," Account No. 865 is offset by "Investment in Branch," Account No. 753;

b) Receivables and payables between the branches and the main office or between the main office and a branch are eliminated; and

c) Intra-office profits or losses are eliminated.

6120.7 ILLUSTRATIVE JOURNAL AND CASH RECORD ENTRIES

Assume that JV Federal Credit Union maintains Branch #1 in another state. Furniture and equipment used at the branch is recorded on the records of the main office. Several operating expenses are applicable to the entire credit union operation. The main office bills the branch for its portion of the allocated cost. The branch was opened December 1, 19X0.

The following transactions occurred during the month of December 19Xl.

6120.7.1 DESCRIPTIONS OF THE TRANSACTIONS

a) Cash of $200,000 was sent to the branch.

b) Furniture and equipment was purchased by the branch for $1,000. The transaction is to be recorded on the records of the main office which is in accordance with the policies of the main office for other assets purchased by the branch.

c) Forty new consumer type loans were granted to credit union members totaling $160,000.

d) Payments on loans that have been processed by the branch amounted to $124,000 including interest.

e) $4,000 of operating expense were paid by the branch.

f) The branch forwarded $76,000 cash to the main office.

g) Operating expenses of $6,000 that were applicable to the branch's operations were billed to the branch by the main office.

Journal and Cash Record Entries

Main Office		
a. Dr. - Investment in Branch #1 (Acct. No. 753.1)	$200,000	
Cr.-Cash (Acct. No. 731)		$200,000
b. Dr. - Furniture and Equipment - Branch #1 (Acct No. 774.1)	$1,000	
Cr.-Investment in Branch #1 (Acct. No. 753.1)		$1,000
c. None		
d. None		
e. None		
f. Dr. - Cash (Acct. No. 731)	$76,000	
Cr.-Investment in Branch #1 (Acct. No. 753.1)		$76,000
g. Dr. - Investment in Branch #1 (Acct. No. 753.1)	$6,000	
Cr.-Operating Expenses (Acct. No. 200)		$6,000

Branch Office		
a. Dr. - Cash (Acct. No. 731)	$200,000	
Cr.-Main Office (Acct. No. 865)		$200,000
b. Dr. - Main Office (Acct. No. 865)	$1,000	
Cr.-Cash (Acct. No. 731)		$1,000
c. Dr.-Loans (Acct. No. 701)	$160,000	
Cr.-Cash (Acct. No. 731)		$160,000
d. Dr. - Cash (Acct. No. 731)	$124,000	
Cr.-Loans (Acct. No. 701)		$100,000
Cr.-Interest on Loans (Acct. No. 111)		$24,000
e. Dr.-Rent (Acct. No. 251)	$4,000	
Cr.-Cash (Acct. No. 731)		$4,000

Branch Office (Continued)

f. Dr. - Main Office (Acct. No. 865) $76,000
Cr.-Cash (Acct. No. 731) $76,000

g. Dr. - Operating Expense
(Acct. No. 200)... $6,000
Cr.-Main Office (Acct. No. 865) $6,000

6120.7.2 RECIPROCAL ACCOUNT IN MAIN OFFICE GENERAL LEDGER

Investment in Branch #1 *(Account No. 753)*

Explanation of the Transaction	Dr.	Cr.	Debit Balance
#1 Cash forwarded to the branch	$200,000		$200,000
#2 Furniture and Equipment purchased			

Reciprocal Account in Main Office Gener Ledger (continued)

by the branch, but recorded in the main office		$1,000	$199,000

Investment in Branch #1 *(Account No. 753)*

Explanation of the Transaction	Dr.	Cr.	Debit Balance
#6 Cash received from the branch		$76,000	$123,000
#7 Operating expenses billed to branch	$6,000		$129,000

6120.7.3 RECIPROCAL ACCOUNT IN BRANCH LEDGER

Main Office *(Account No. 865)*

Explanation of the Transaction	Dr.	Cr.	Credit Balance
#1 Cash received from main office		$200,000	$200,000
#2 Equipment purchases by branch to be recorded on the books of the main office	$1,000		$199,000
#6 Cash sent to home office	$76,000		$123,000
#7 Operating Expenses billed by home office		$6,000	$129,000

6125 SPECIAL ACCOUNTING AND OPERATING PROCEDURES FOR FEDERAL CREDIT UNIONS MAINTAINING OFFICES OVERSEAS

Federal credit unions whose fields of membership have been expanded to include personnel at military bases overseas are presented with new opportunities to extend valuable credit union services. Undoubtedly, the greatest challenge will be to provide prompt and complete service to the members overseas in spite of the geographical distance that separates the overseas base from the credit union office in the United States.

A federal credit union submitting a proposal to the National Credit Union Administration to include overseas installations in its field of membership should include information on the accounting and operating procedures which will be used in operating the overseas office. Information concerning the accounting and operating procedures should be submitted to the Administration's regional office serving the area in which the credit union's home office is located.

In summarizing the operating procedures it should be kept in mind that the need to maintain duplicate records may be substantially reduced for federal credit unions that use a computerized accounting system. Since there are variances in the types of computer systems used by federal credit unions, it is not practical to identify a uniform method that each of these credit unions should follow in serving the overseas office.

Consequently, a federal credit union using a computer system should submit a description of the procedures it intends to use in servicing the overseas office. Comments on the frequency of transmittal of specific types of documents between offices will need to be included. Copies of output documents to be used by the overseas facility as substitutes for maintaining duplicate records should be submitted with the description.

6125.1 ACCOUNTING AND OPERATING PROCEDURES

The accounting and operating procedures discussed herein provide the framework in which overseas members can receive appropriate service. The procedures are based on the assumptions that the overseas office will accept payments from members and make all disbursements to them.

The accounting and operating procedures are discussed in three major sections as follows:

a) Special Considerations;

b) Overseas Procedures; and

c) Main Office Procedures.

In most instances, these procedures can be followed with few changes. Where necessary, however, requests for waivers should be sent to the Regional Directors for review and transmittal to the Administrator for action.

6125.2 SPECIAL CONSIDERATIONS

6125.2.1 RESPONSIBILITY FOR OPERATIONS

The board of directors, credit committee and supervisory committee are responsible for the operations of a federal credit union. The operation of an overseas office of the credit union places increased responsibility on the officials at the main office in guiding and directing the affairs of the credit union at each of its branch locations.

6125.2.2 ALLOTMENTS

Allotment checks and supporting data showing the individual allotments should be sent to the office serving the members at that location. Members stationed at the overseas location should designate the overseas office as recipient of their allotments. All other members should designate the main office as recipient.

6125.2.3 FOREIGN CURRENCY TRANSACTIONS

Statement of Financial Accounting Standards (SFAS) No. 52 sets forth accounting standards for foreign operations. FASB 52 would usually only affect credit unions with regard to foreign currency transactions. A foreign currency transaction takes place whenever a monetary transaction occurs in a currency other than the functional currency of the branch. For purposes of SFAS No. 52, the “functional currency” of the branch would normally be U.S. dollars.

SFAS No. 52 requires that financial statements be adjusted to reflect the current value of foreign currency on deposit at the overseas branch. This is referred to as “Translation Adjustments.” Translation adjustments may result in a gain or loss that would have to be reflected on the financial statement. translation adjustments are calculated by taking the difference between the exchange rate that could have been used to settle the transaction on the date it occurred and the exchange rate that exists as of the balance sheet date.

Example: A member makes a share deposit in a foreign currency of $50 and the exchange rate on that day is 1.25. In U.S. dollars the deposit is worth $40 ($50 divided by 1.25). When the month-end financial statements are prepared, the exchange rate has changed to 1.20. The deposit is now worth $41.67, or a gain of $1.67. This gain of $1.67 should be recorded on the income statement as a gain on foreign currency transactions.

6125.3 OVERSEAS PROCEDURES

6125.3.1 RECORDS

In order for the overseas office to carry on day-to-day operations with the members at the facility, it is necessary that certain records be maintained overseas. These records should be duplicated and the official records maintained at the main office.

6125.3.1.1 MINIMUM RECORDS TO BE MAINTAINED AT OVERSEAS OFFICE

a) Duplicates of cash received, cash disbursed and journal vouchers, along with any summary vouchers prepared.

b) Duplicates of records reflecting allotment postings.

c) Duplicates of membership application cards or some other means of identifying the members.

d) A Daily Log for Cash, Shares and Loans, except for centralized, computerized recordkeeping systems.

e) Duplicates of the Individual Share and Loan Ledgers, except for centralized, computerized recordkeeping systems.

6125.3.1.2 RECORDS AND INFORMATION TO BE TRANSMITTED BY THE OVERSEAS OFFICE TO THE MAIN OFFICE

Daily

a) Originals of all cash received, cash disbursed and journal vouchers, along with each day's summary vouchers.

b) The breakdown (Shares, Loans, Interest and Late Charges) of any allotment posting.

c) Invoices for expenses paid.

d) Notes and supporting documents for loans made (microfilmed, microfiched, photostatic copies, or the original documents).

e) Applications for loans and extension agreements to be considered by the credit committee (including applications submitted to the loan officer but not approved by the loan officer).

f) Requests for withdrawal of shares requiring credit committee approval.

g) Membership applications.

h) Loan officer records (credit committee may require weekly submittal).

Monthly

a) Month-end tapes of the Individual Share and Loan Ledger balances, except for centralized, computerized recordkeeping systems.

b) Membership officer report, if membership officer is located overseas.

c) Month-end cumulative totals of Cash, Shares and Loans from the Daily Log, except for centralized, computerized recordkeeping systems.

6125.3.2 OPERATIONS

6125.3.2.1 RECEIPTS

To record cash receipts at the overseas office, three copies of the cash received voucher should be prepared. One voucher is transmitted to the main office; a second copy is filed at the overseas location after posting, and the third copy given to the member as his receipt. (If passbooks are used, the triplicate copy need not be prepared.)

Cash receipts should be balanced in accordance with the instructions in Sections 5010, 5050, and 5060. An original and a copy of the summary voucher should be prepared for all cash received vouchers of the day. The original summary should be transmitted to the main office with the original vouchers. The duplicate summary should be filed in the overseas office with the copies of the vouchers.

6125.3.2.2 DEPOSITS MADE BY AN OVERSEAS BRANCH

A separate bank account must be opened for the overseas office. Eligible depositories under the Federal Credit Union Act include branches of stateside banks and local banks that are correspondents of stateside banks. If there are no such branches or banks available at or near the overseas facility, the account should be maintained in a stateside bank. In that event, cash receipts will need to be transmitted to the bank. Money orders may be used for this purpose. It may be possible to make an arrangement with the financial officer on the military base where cash turned over to him/her will be transmitted to the main office or designated depository.

Arrangements should be made so that both the main office and the overseas office receive validated bank deposit tickets for deposits made by the overseas office.

6125.3.2.3 DISBURSEMENTS

Disbursements to members whose accounts are at the overseas office should be made by the overseas office. Consequently, all requests for share withdrawals and loan applications by members whose accounts are at the overseas office should be presented to that office. Careful separation of account activity between members at the overseas office versus members at the main office is a crucial aspect of overseas office control.

Many requests for disbursements, including loans and share withdrawals that the loan officer approves pursuant to delegated authority can be fulfilled without referral to the main office. Those requests which do require further main office action, should be referred to the main office for approval or disapproval. After action has been taken on these items, approval and rejection advices should be sent to the overseas office in whatever form the credit union finds workable.

All overseas disbursements should be supported by vouchers. The original vouchers, along with the summary, are usually sent to the main office. The duplicates, along with the duplicates of the summary, are to be filed at the overseas office. If the main office desires a posting copy in addition to a check register copy, an additional copy of the voucher should be prepared. Notes and supporting documents (or facsimiles thereof) for loans disbursed at the overseas office are usually sent to the main office for filing; however if the board of directors so decide, these documents can be maintained at the overseas office.

Expenses incurred at the overseas office should be paid by that office. An exception to this policy would be the payment of salaries to the overseas office employees by the main office.

6125.3.2.4 DAILY LOG

The overseas office should maintain a Daily Log into which the debits and credits of Cash, Shares and Loans from each day's summary vouchers are entered. At the end of each month, the cumulative totals of the Daily Log should be determined.

6125.3.2.5 ALLOTMENTS

Overseas members should designate the overseas office as recipient of their allotments. Each time the overseas office posts allotments, it should furnish the main office with the posting information so that the official Individual Share and Loan Ledgers can be updated.

6125.3.2.6 RECORD OF LOANS MADE

If the overseas office does not retain loan applications, it is necessary that a record of loans made be maintained. The basic information shown on the record portion of the Individual Share and Loan Ledger (plus any additional information that is necessary for the loan officer to act on applications for loan(s) should be recorded. An example of additional information which would be helpful is the "purpose" of the previous loan(s).

6125.3.2.7 LOANS TO PURCHASE SECURITIES

A borrower who is a citizen or a resident of the United States obtaining credit from an overseas office of an FCU registered under Regulation G must comply with the provisions of Regulation G if the purpose of the loan is to purchase listed securities. The borrower is not required to complete Part I of Federal Reserve Form G-3 (concerning a statement of the purpose of the credit). However, it is recommended that a federal credit union encourage the member to fill out the purpose statement. This practice should eliminate any potential penalties that could arise should the member use the borrowed funds to purchase something other than listed securities.

6125.4 MAIN OFFICE PROCEDURES

6125.4.1 RECORDS

The main office is charged with the responsibility of maintaining all official records for the overseas office in addition to the main office records. The main office, therefore, needs to maintain the same records for overseas members as it maintains for the members at the stateside location. The fact that the overseas office is required to maintain duplicate records in order to provide prompt service does not relieve the main office from keeping a complete set of records.

6125.4.1.1 RECORDS TO BE MAINTAINED AT THE MAIN OFFICE

a) All records now maintained for main office transaction.

b) All records reflecting overseas transactions.

c) Daily cash balance of bank account for overseas office.

d) Duplicate copies of approval and rejection advices sent to overseas office.

6125.4.1.2 INDIVIDUAL SHARE AND LOAN LEDGERS (DUPLICATES)

The balances on the Individual Share and Loan ledgers are updated daily. These ledgers must be clearly marked “duplicate.”

Trial balance tapes of the duplicate Individual Share and Loan Ledgers must be prepared each month-end and balanced to the Share and Loan totals in the Daily Log. One copy of the tapes should be sent to the main office for confirmation with the official records.

6125.4.1.3 JOURNAL AND CASH RECORD AND GENERAL LEDGER

To provide the credit unions officials with the information they need to analyze the overseas operations, separate Journal and Cash Records and General Ledgers (designated as “main office” and “overseas”) should be maintained. In addition, in order that transactions between the two offices can be properly reflected in the separate records maintained for each office, it is necessary to use the reciprocal accounts, Account. Nos. 753 and 865.

At the end of each month, the “main office” Journal and Cash Record is closed, and the totals are posted to the “main office” General Ledger. Trial balances are prepared of the Individual Share and Loan Ledgers for the “main office” accounts, and the balances are reconciled to their respective “main office” General Ledger accounts.

The monthend tapes of the overseas office, which have been prepared by the main office, should then be reconciled to the tapes furnished by the overseas office. All balances on the tapes must be as of the last business day of the period. Any differences should be promptly reconciled with the overseas office. A Statement of Financial Condition and related period-end reports should then be prepared for the main office.

The “overseas” Journal and Cash Record should be held open until all vouchers for the month are received. After these transactions are entered into the “overseas” Journal and Cash Record and posted to the “overseas” Individual Share and Loan Ledgers, the “overseas” Individual Share and Loan Ledgers, and the balances should be reconciled to their respective “overseas” General Ledger accounts. A Statement of Financial Condition and related period-end reports should then be prepared for the overseas office. As a final step, a consolidated Statement of Financial Condition and related period-end reports should be prepared.

6125.4.1.4 SCHEDULE OF DELINQUENT LOANS

At the end of each month (or more frequently if dividends are distributed more frequently than monthly) the main office should prepare a Schedule of Delinquent Loans. A combined schedule or separate schedules for the overseas office and the main office can be prepared. A copy of the combined schedule, which specifically identifies the delinquent loans at the overseas office (or the separate schedule which fists only the delinquent loans at the overseas office), should be furnished to the overseas office on a monthly basis (more frequently if needed).

If the credit union follows the practice of transferring to the main office the accounts of those members who leave the overseas base, then a procedure should be developed to identify those loans which subsequently become delinquent. The total of the number and amount of these loans which subsequently become delinquent should be shown in the statistical section of the Statement of Income (FCU 109B) of both the overseas office and the main office. A note to the financial statements should identify the total of the number and amount of delinquent loans attributed to the overseas branch and the main office.

6125.4.1.5 STATEMENT OF ACCOUNT

Assuming that statements of accounts are used, they should be mailed by the main office to all overseas members.

6125.4.1.6 SUPERVISORY COMMITTEE

The supervisory committee should determine the date and scope of audits to be performed at the overseas location and inform its overseas assistant and/or accounting firm. Since the official records should be maintained at the main office, verification of members’ accounts should originate from the main office.

6125.4.1.7 OTHER ACCOUNTING ENTRIES

At the end of each accounting period, the income and expense accounts should be closed to “Net Income (Loss)” on the respective records of the overseas office and main office. Valuation allowance adjustments, dividends, and interest refunds should be recorded on the respective records before the income and expense accounts are closed to “Net Income (Loss)”, in accordance with the instructions in Sections 4000 and 5000 of this manual. The net income or loss generated on the records of the overseas office should then be transferred to the main office records through the use of the reciprocal accounts. The apportionment of income or loss between the "Regular Reserve" and "Undivided Earnings" accounts should then be made on the main office records. "Undivided Earnings" and "Regular Reserve" accounts should not be established for the overseas office.

Any loans to be charged off should be charged to the "Allowance for Loan Losses," (Account No. 719) in the main office records. Refer to Section 6125.5 for a listing of the proper accounting entries to be used when a loan is transferred to the main office. Recoveries should, likewise, be credited to the main office "Allowance for Loan Losses," (Account No. 719). The Statement of Income (FCU 109B) should receive allocation of the "Provision for Loan Losses Expense," (Account No. 300) and be footnoted for charge-offs and recoveries of overseas loans.

6125.5 ILLUSTRATIVE OPERATIONAL ENTRIES

The following illustrative entries reflect typical transactions between the main office and overseas branch office.

Illustrative Entries:

a) To record cash transferred from branch office to main office:

Dr. - Main Office (Acct. No. 865) $300
Cr.-Cash (Acct. No. 731) $300

Main Office:

Dr. - Cash (Acct. No. 731) $300
Cr.-Investment in Branch
(Acct. No. 753) $300

b) To record transfer of a loan loss to Main Office for collection and/or charge-off:

Branch Office:

Dr. - Main Office (Acct. No. 865) $175
Cr.-Loans (Acct. No. 701) ....
$175

Main Office:

Dr.-Loans (Acct. No. 701) $175
Cr.-Investment in Branch

(Acct. No. 753) $175

c) To record transfer of allowance established for above loan transferred to Main Office:

Branch Office:

Dr. - Allowance for Loan Losses
(Acct. No. 719) $175
Cr.-Main Office (Acct. No. 865) $175

Main Office:

Dr.-Investment in Branch
(Acct. No. 753) $175
Cr.-Allowance for Loan Losses
(Acct. No. 719) $175

d) To record the charge-off of a loan that is on the records of the Branch office:

Branch Office:

Dr. - Main Office (Acct. No. 865) $125
Cr.-Loans (Acct. No. 701) $125

Main Office:

Dr. - Allowance for Loan Losses
(Acct. No. 719) $125
Cr.-Investment in Branch
(Acct. No. 753) $125

6125.5.1 ILLUSTRATIVE ENTRIES FOR THE END OF THE ACCOUNTING PERIOD

a) To adjust valuation allowance for loans at branch office as required by directors:

Branch Office:

Dr. -Provision for Loan Losses
(Acct. No. 300) $55
Cr.-Allowance for Loan Losses
(Acct. No. 719) $55

Main Office:

No Entry Needed

b) To record dividends declared for branch office accounts:

Branch Office:

Dr. - Dividend Expense (Acct. No. 380) $125
Cr.-Dividends Payable (Acct. No. 820) $125

Main Office:

No Entry Needed

c) To close interest on loans to Net Income (Loss) for the branch office:

Branch Office:

Dr.-Interest on Loans (Acct. No. 111) $400
Cr.-Net Income (Loss)
(Acct. No. 960) $400

Main Office:

No Entry Needed

d) To close expense control to Net Income (Loss) for the branch office:

Branch Office:

Dr.-Net Income (Loss)
(Acct. No. 960) $100
Cr.-Operating Expenses (Control)
(Acct. No. 200) $100

e) To transfer Net Income (Loss) from records of branch office to records to main office:

Branch Office:

Dr.-Net Income (Loss)
(Acct. No. 960) $300
Cr.-Main Office (Acct. No. 865) ....
$300

Main Office:

Dr. -Investment in Branch Office
(Acct. No. 753) $300

Cr.-Net Income (Loss)
(Acct. No. 960 .... $300

The apportionment of the combined Net Income (Loss) between Regular Reserve and Undivided Earnings is then made on the main office records.

6128 CREDIT UNION OFFICE FACILITIES ON DEPARTMENT OF DEFENSE INSTALLATIONS

Federal credit unions that have offices on military installations may have the option of using either available real property space, or constructing their own facilities. The following instructions concern the prescribed procedure for such credit unions to account for funds expended for office facilities. Authority for this activity is contained in Department of Defense Directive 1000.10. Details are shown in the regulations issued by each concerned military department.

6128.1 GOVERNMENT-OWNED FACILITY

When a credit union has used its own funds to expand, modify, or renovate government-owned space, a no-cost permit or license may be provided for a period not to exceed 26 years. The duration of the permit or license is to be commensurate with the extent of the improvements as determined by the DOD component concerned. The leasehold improvements, in this situation, would thus need to be amortized over the term of the license or permit or the economic life of the improvements, whichever is less. The unamortized portion of the leasehold improvement should be shown as a separate asset account, “Leasehold Improvements,” (Account Number 776). Periodic charges to amortize the asset account would be to “Amortization of Leasehold Improvements,” (Account Number 255).

6128.2 OFFICE FACILITIES CONSTRUCTED BY FEDERAL CREDIT UNIONS

Federal credit unions that construct office facilities on government installations must agree to certain conditions required by the aforementioned DOD Directive 1000.10. These conditions are that the facilities would revert to the government without reimbursement to the credit union upon the revocation of the lease, closing of the installation or the liquidation of the credit union.

The DOD currently encourages credit unions to construct buildings off-base rather than on-base so that the credit union does not suffer in case of an installation closure. In addition, credit unions should be aware that current DOD policy limits leases for new construction to 25 years or less. Some credit unions are currently operating under 15 year leases, which was the previous maximum period allowed by DOD. The credit union’s financial statement should be noted to indicate the improvement is owned by the U.S. Government and the credit union is permitted to occupy it at no cost to the credit union.

For those credit unions that have constructed buildings on DOD installations, either independently or as a part of a complex, such as an installation shopping mall, land for buildings should be provided to the credit union in the form of a real estate land lease, at a fair market rental, for a period not to exceed 25 years.

When under the land lease, title to the buildings and other improvements to the land has passed to the government, arrangements should be made for the credit union's continued occupancy of those premises by a no-cost permit or license. Such arrangements will continue for as long as the credit union desires occupancy. Continued renewal of the permit will only cease under those conditions which would have caused cessation of the predecessor lease. Under these circumstances, the amortization period for the building and improvements to the land would be their economic life.

If a federal credit union erects an on-site building under the above conditions, the cost should be shown in "Leased Assets," (Account No. 778). Periodic amortization charges should be made to "Depreciation of Leased Assets," (Account No. 257).

6128.3 OFF-SITE OFFICE FACILITY

Expenditures for an office building constructed by a defense credit union which is not on a military installation should be handled in accordance with the instructions for "Building," (Account No. 772).

If a credit union constructed both on-site and offsite buildings, two separate asset accounts should be shown in its General Ledger and in its financial statement. The building located off-site would have its costs recorded in "Building," (Account No. 772), with any land cost recorded in "Land," (Account No. 771), while the building located on the installation would be shown in "Leased Assets," (Account No. 778).

6128.4 RISK ASSETS

For the purpose of establishing the reserves required by Section 116 of the Federal Credit Union Act, assets shown in "Leasehold Improvements," (Account No. 776), will not be considered as risk assets.

6130 CORPORATE CENTRAL CREDIT UNIONS

Corporate central credit unions were established to serve primarily other credit unions. A corporate central federal credit union is defined as a federal credit union whose total dollar amount of outstanding corporate loans plus corporate shareholdings is equal to, or in excess of, 75 percent of its total outstanding loans plus shareholdings (corporate accounts are accounts of natural person credit unions). Additional information about corporate credit unions may be found in Part 704 of the NCUA Rules and Regulations.

The corporate central credit union can service the natural person credit union in two specific ways:

a) By giving the natural person credit union a place to invest its excess funds; and

b) By being able to lend to natural person credit unions for needs which are seasonal or short-term. In emergency situations, the corporate central credit union may also be able to provide long-term financing.

When the corporate central credit union is able to meet these objectives, it is fulfilling its role in the liquidity management of the credit union system.

For accounting purposes, investments in a corporate central credit union will be recorded in "Shares, Deposits and Certificates in Corporate Centrals," (Account No. 744); and loans from the corporate central should be recorded in "Notes Payable-Other," (Account No. 812). Income from the shares, deposits, and certificates should be recorded in "Income from Shares, Deposits and Certificates in Corporate Credit Unions," (Account No. 126). Additional information on accounting for these accounts in the General Ledger can be found in Section 4000 of this manual.

Corporate central federal credit unions can become Agent members to the Central Liquidity Facility. The main purpose for a corporate central to become an Agent is to assure financial stability by providing its member natural person credit unions with a source of loans to meet their liquidity needs. If a corporate central becomes an Agent, all of its member natural person credit unions can use the Central Liquidity Facility but only through the corporate central. Refer to Section 6090, "Membership in Central Liquidity Facility" for further information on Agent membership and required stock subscriptions.

6140 PENSIONS

A pension plan is a contract between a credit union and its employees whereby the credit union agrees to pay benefits to employees upon their retirement. Pension benefits generally consist of monthly payments and may provide for additional payments when employees die or becomes disabled.

A pension plan may be formal or implied by credit union practice. The plan may be established by an individual federal credit union or collectively with other credit unions.

There is no restriction on the types of pension plans credit unions may provide for their employees; however, credit unions should look for pension plans providing the most benefits at the lowest cost.

Federal credit unions may establish pension plans for their employees, or they may join existing programs as follows:

a) As the sponsor of an employee pension benefit plan for employees and compensated officers of the credit union with a named trustee other than the credit union;

b) As the trustee or custodian for individual retirement accounts (IRAs) for employees and compensated officers of the credit union;

c) As the trustee or custodian for individual retirement accounts (IRAs) for credit union members, groups of members, or organizations of members; or

d) As the trust or custodian for self-employment plans (Keoghs) for credit union members, groups of members, or organizations of members.

Due to their complexity, participation in any of these plans should only be undertaken with the advice of legal counsel. In addition, participation in any of the above plans (where the retirement funds are to be placed in trust or custodial accounts in the credit union) would require that credit unions comply with Article III, Sections 5(d), 5(e) and 6 of the Bylaws for Federal Credit Unions, and 724 and 745 of the NCUA Rules and Regulations as they relate to these types of accounts. Finally, credit unions should obtain outside assistance to determine whether the are complying with IRS regulations, Pension Benefit Guaranty Corporation (PBGC) guidelines and Department of Labor requirements.

Federal credit unions are authorized to have funded or unfunded pension plans for their employees. Under funded plans, regular periodic payments are made to an insurance company or to a trustee which agrees to assume the responsibility of distributing retirement checks to the designated recipients. Under unfunded plans, pension payments would be made by federal credit unions directly to their retired workers. The plans may be contributory where the employees bear part of the cost or they may be noncontributory where the credit unions pay the entire cost.

When a federal credit union acts as a trustee or custodian of a pension plan, the plan must consist of Individual Retirement Accounts and/or Keogh Accounts. The accounts must be established pursuant to Part 724 of the NCUA Rules and Regulations. Fiduciary liability insurance is not required.

When the federal credit union does not act as trustee or custodian, the plan needs to provide for the appointment of a trustee or custodian that is a person, committee, or organization other than the credit union.

A federal credit union acting as a trustee or custodian of individual retirement plans of its members established pursuant to the Employee Retirement Income Security Act of 1974 or self-employed retirement plans established pursuant to the Self Employed Individuals Retirement Act of 1962, *can do so only if:*

a) All contributions of funds are initially made to a share or share certificate account in the credit union;

b) Any subsequent transfer of funds to other assets is solely at the direction of the member and the federal credit union exercises no investment discretion and provides no investment advice with respect to plan assets (i.e., the credit union performs only custodial duties);

c) The member is clearly notified of the fact that NCUSIF coverage is limited to funds held in share or share certificate accounts of federally insured credit unions; and

d) The federal credit union complies with all applicable provisions of the Federal Credit Union Act and the NCUA Rules and Regulations, and applicable laws and regulations as may be promulgated by the Secretary of Labor, the Secretary of the Treasury, or any other authority exercising jurisdiction over such trust or custodial accounts.

Pension plans may be initiated when a credit union is organized or, as in most credit unions, several years subsequent to its organization. If a pension plan is initiated upon organization, the credit union would incur normal pension costs.

However, if the plan is initiated subsequent to the credit union's organization, employees would be given past service credits for prior years' employment. The service credit should be included in the prior service cost as defined in Section 6140.1.

6140.1 DEFINITIONS

Accumulated Benefit Obligation. The actuarial present value of vested and/or non-vested retirement benefits attributed by the pension benefit formula to employee service before a certain date based on employee service and/or employee compensation prior to that date.

Actual Return on Plan Assets. The difference between the fair value of the plan assets at the beginning and at the end of a measurement period, adjusting for all payments and contributions during that period.

Actuarial Present Value. The current value of an amount or series of amounts, with each amount discounted for interest and the probability of payment between the specified date and the expected date of payment.

Annuity Contract. A contract whereby an insurance company unconditionally guarantees to provide specified pension benefits to specific individuals in return for a fixed premium.

Assumptions. Estimates of the occurrence of future events affecting pension costs, such as mortality, withdrawal, disablement, and retirement, changes in compensation, and discount rates.

Attribution. The process of assigning pension costs to periods of employee service.

Defined Benefit Pension Plan. A pension plan that determines an amount of pension benefit to be provided, usually as a function of age, years of employment, and/or compensation.

Defined Contribution Plan. A plan providing pension benefits which specifies the contributions to be made to the plan rather than specifying the benefits an employee is to receive. The retiree simply receives the balance of his account (or the actuarial equivalent) at the time his benefits begin. To meet its obligation, a credit union having such a plan needs only to make the contributions required by the funding provision of the plan.

Expected Long Term Rate of Return on Plan Assets. An assumption regarding the rate of return on plan assets reflecting the average rate of earnings expected on the investments in the retirement fund to provide the benefits.

Final Pay Formula/Plan. A benefit formula basing benefits on the employee's compensation over a certain number of years near the end of his employment period.

Flat Benefit Formula/Plan. A benefit formula basing benefits on a fixed amount per year of service.

Funding Policy. The plan for investing and timing credit union contributions to provide retirement benefits.

Gain or Loss. A change in the value of either the projected benefit obligation or the plan assets, or both.

Gain or Loss as a Component of Net Periodic Pension Cost. The sum of two factors:

a) The difference between the actual return on plan assets and the expected return on plan assets, and

b) The amortization of the unrecognized net gain or loss from previous periods.

Interest as a Component of Net Periodic Pension Cost. The increase in the projected retirement obligation due to passage of time.

Net Periodic Pension Cost. The amount recognized as pension plan cost in the credit union's financial statements.

Pension Benefit Formula. The formula for determining retirement payments to entitled participants under the pension plan.

Plan Amendment. A change in the terms of an existing plan or the beginning of a new plan.

Plan Assets. Assets which have been segregated and restricted to provide pension plan benefits.

Plan Curtailment. An event significantly reducing the expected years of future employment of employees or eliminating the accrual of benefits for a significant number of employees for some or all of their future services.

Plan Termination. An event resulting in the cessation the pension plan and the settlement of pension benefits. Termination may result in the purchase of annuities or lump sum payments in settlement of the pension benefits.

Prepaid Pension Cost. Accumulated employer contributions in excess of accrued net pension costs.

Prior Service Cost. The cost of retroactive benefits granted in a plan amendment, or the initiation of a plan subsequent to a credit union's organization.

Projected Benefit Obligation. The actuarial present value of all benefits attributed by the pension benefit formula as of a certain date to employee service rendered prior to that date.

Retroactive Benefits. Benefits granted in a plan amendment or initiation attributed to employee service by the pension benefit formula prior to the amendment or the initiation.

Service. Employment considered eligible to earn benefits by the pension benefit formula.

Service Cost Component of Net Periodic Pension Cost. The actuarial present value of retirement benefits earned under the pension benefit formula during a particular period.

Settlement. An irrevocable transaction relieving the credit union or the plan of primary responsibility for pension benefits and eliminating significant risks related to the obligations and the assets used to pay for the settlement.

Unfunded Accrued Pension Cost. Accumulated net pension cost accrued in excess of the credit union's contributions.

Unrecognized Prior Service Cost as a Component of Net Periodic Pension Cost. The portion of prior service cost which has not yet been recognized by the credit union as part of net periodic cost.

Vested Benefits. Benefits already earned by the employee through service.

6140.2 ACCOUNTING FOR PENSION COSTS

When considering pension plans, deferred compensation agreements are often considered at the same time. The accounting treatment and the disclosure requirements for deferred compensation agreements are covered in section 6140.7 and related subsections.

Pension plans may be defined contribution or defined benefit plans. Defined contribution plans are discussed in section 6140.9.

For purposes of this section, a defined benefit pension represents an exchange between a credit union and its employees. In exchange for services, the credit union agrees to provide, in addition to current compensation, an amount of retirement income.

Pensions, therefore, are not gratuities, but are part of an employee's basic compensation. Since retirement income is not received currently, but is instead deferred until retirement, a pension is a form of deferred compensation. The credit union's obligation is incurred, however, when the services are rendered.

There are three basic aspects of pension accounting: delaying recognition of certain events, reporting net cost, and offsetting liabilities and assets.

Delayed recognition means that credit unions do not recognize changes in the pension obligation and/or changes in the value of the assets dedicated to meet those obligations as they occur, but gradually and systematically over later periods.

Net cost means that credit unions report all components of net pension benefits as one cost, rather than separately breaking down the compensation cost, the interest cost, and the income from investing what are often substantial amounts.

Offsetting refers to the fact that credit unions recognize the net values of assets contributed to pension plans and pension liabilities for past periods on their statements of financial position (balance sheets) even though the liabilities have not been settled, the assets may still be substantially controlled, and substantial risks and rewards associated with both of those amounts are clearly still borne by the credit unions.

Credit unions are required to recognize minimum liabilities in certain circumstances when the accumulated benefit obligation exceeds the fair value of plan assets, even though recognition of the offsetting increase in net periodic pension cost is delayed over subsequent periods.

Net pension costs, as all other components of compensation costs, should be recognized by credit unions in the periods in which their employees render service. Even though the complexity and uncertainties of some plans may preclude complete achievement of that goal, it is the intent here to approximate more closely the recognition of the compensation cost of credit unions' pension benefits over its employees' service periods.

In accounting for pension costs, various problems arise such as:

a) allocating the pension costs to their applicable periods;

b) reporting the correct amounts for the rights and obligations in existence at different time periods;

c) disclosing the major terms or provisions of the plan, including the amount and time of the payments to be paid into the fund;

d) calculating the net periodic pension cost; and,

e) distributing the pension costs into their proper periods in a manner that will cause the costs to match the net revenue.

When accounting for pension costs, it should be assumed that the credit union will continue to provide the pension plan benefits. This assumption implies that the pension plan is a long-term undertaking, the cost of which will be recognized at least annually by those credit unions on a modified cash basis of accounting, and monthly by those credit unions on a full accrual method of accounting.

The entire cost of benefit payments should be charged against current period income. No portion of the cost should be charged against Undivided Earnings as a prior period adjustment.

6140.2.1 DETERMINATION OF NET PERIODIC PENSION COST

The net periodic pension cost is to be determined using the following components:

a) Service cost-The actuarial present value of benefits attributed by the pension benefit formula to employee services rendered by employees during that period. The service cost component is a portion of the projected benefit obligation and is unaffected by the funded status of the plan.

b) Interest cost-The increase in the projected benefit obligation due to passage of time.

c) Actual return on plan assets, if any-The difference between fair value of plan assets at the end of the period and the fair value at the beginning of the period, adjusted for contributions and payments of benefits during the period.

d) Amortization of unrecognized prior service cost, if any-The systematic recognition, over several periods, as a charge to current income, of that portion of prior service cost that has not been recognized as a part of the net periodic pension cost.

e) Gain or loss (including the effects of changes in assumptions) to the extent recognized-The sum of (a) the difference between the actual return on plan assets and the expected return on plan assets and (b) the amortization of the unrecognized net gain or loss from previous periods. The gain or loss component is the net effect of delayed recognition of gains and losses (the net change in the unrecognized gain or loss) except that it does not include changes in the projected benefit obligation occurring during the period and deferred for later recognition.

f) Amortization of the unrecognized net obligation (and loss or cost) or unrecognized net asset (and gain) existing at the date of initial application of this section-The systematic recognition, over several periods, as a charge to current income, of the difference between the projected benefit obligation and fair value of pension assets, plus previously recognized unfunded accrued pension cost or less previously recognized prepaid pension cost.

6140.2.2 ILLUSTRATION OF NET PERIODIC PENSION COST COMPUTATION

For simplicity, it is assumed for this Illustration that there are no differences (actuarial gains or losses) between the actual amounts and those estimated at the end of the accounting period, and that the credit union made no contributions to the pension fund during the period.

Service cost component	$1,000
Interest cost component	500
Actual Return on plan assets	(750)
Amortization of unrecognized prior service cost	300
Amortization of unrecognized net (gain) or loss	300
Amortization of initial unrecognized net obligation (asset)	450
Total net periodic pension cost accrual	$1,800

6140.2.3 PROVISION FOR VESTED BENEFITS

Earned pension benefits that are not contingent on the employee remaining in the service of the credit union are known as vested benefits. If the credit union is maintaining a provision account for vested benefits, this account should be maintained until such time as the balance in the account is cleared.

Under the Net Periodic Pension Cost Method, the amortization of the vested benefits would be included in the Cost Component "Amortization of the unrecognized net obligation (and loss or cost) or unrecognized net asset (and gain) existing at the date of initial application of this section."

6140.3 ACTUARIAL GAINS AND LOSSES

These gains and losses are equal to the difference between actuarial assumptions and existing actuarial conditions affecting the total pension cost. In the previous Accounting Manual for Federal Credit Unions, we included a description of the various methods to account for actuarial gains and losses. As a result of the changes in accounting methods for pension plans, a discussion on the several methods has been deleted.

If a credit union becomes involved in a pension plan, the trustee should be able to provide the information necessary to properly account for the pension plan. Whether the credit union acts as a trustee for pension plans involving IRA/Keogh accounts or provides a pension plan through an outside trustee, competent outside assistance should be used if needed to insure compliance with generally accepted accounting principles.

6140.4 RECORDING PENSION ASSETS AND LIABILITIES

The difference between the total contribution to the pension plan for the period and the net periodic pension cost shall be recognized as an "Unfunded Accrued Pension Cost" or as a "Prepaid Pension Cost." If vested pension rights exist, they should be accounted for as outlined in Section 6140.2.3 "Provision for Vested Benefits."

On the "Statement of Financial Condition," there should be full disclosure (in the form of notes) describing the pension plan, a breakdown of the net periodic pension costs, a schedule reconciling the funded status, the weighted averages used for computing the projected benefit obligation and long-term rate of return on plan assets, and disclosures of securities, annuities and amortization methods of the plan.

Due to the complex nature of accounting for pension plans, the credit union should obtain competent outside assistance, if needed, to fully comply with generally accepted accounting principles and disclosure requirements.

6140.5 ILLUSTRATIVE JOURNAL ENTRIES

Example 1. To record the net periodic pension cost accrual as computed in Section 6140.2.2.

Dr. - Net Periodic Pension Cost
(Acct. No. 221 - Pension
Plan Cost).. $1,800

Cr.-Deferred Pension Cost
(Acct. No. 767) or Liability
Under Pension Cost
(Acct. No. 861) $1,800

Dr. - Deferred Pension Cost
(Acct. No. 767) or Liability
Under Pension Cost (Acct.
No. 861) $1,800

For those credit unions on a modified cash basis, the entry would be to debit the net periodic pension cost and credit cash instead of crediting prepaid/ accrued pension cost.

Example 2. To record an additional liability to reflect the required minimum liability. Based upon information provided by the trustee of the credit union's pension plan an additional liability may have to be recognized if an unfunded accumulated benefit obligation exists and:

a) An asset has been recognized as prepaid pension cost,

b) The liability already recognized as unfunded accrued pension cost is less than the unfunded accumulated benefit obligation, or

c) No accrued or prepaid pension cost has been recognized.

Assuming that an additional liability of $60 exists then the following entry is made:

Dr. - Intangible Assets As Part of
Pension Plan (Acct. No. 799) $50
Cr.-Additional Liability as Part
of Pension Plan (Acct. No. 869) $50

Credit unions should seek outside assistance as the accounting entries become more complex in nature.

6140.6 REQUIRED DISCLOSURE FOR POST EMPLOYMENT HEALTH CARE BENEFITS AND LIFE INSURANCE

A credit union providing postretirement health care or life insurance benefits to retirees, their dependents, or survivors is to disclose at least the following information:

a) A description of the benefits provided and the employees groups covered;

b) A description of the accounting and funding policies followed for those benefits;

c) The cost of those benefits, if they can be readily separable from the cost of providing those benefits for active employees, or if they can be reasonably estimated; and

d) The effect of significant matters, accounting or otherwise, affecting the comparability of the costs recognized for all periods presented.

Credit unions should use reasonable methods to estimate the costs of postretirement health and fife insurance benefits. The disclosures may be made separately for each type of benefit, or they may be made in total for all benefits.

If the cost of any postretirement benefits cannot be readily separated from the cost of providing such benefits for active employees, or otherwise reasonably estimated, the total cost of providing those benefits to both active employees and retirees, covered by the plan, is to be disclosed by the credit union.

Due to the complex nature of accounting for post employment health care benefit and life insurance plans, credit unions should obtain guidance from an independent accountant concerning proper accounting treatment and to ensure that their disclosures meet applicable requirements. They should also obtain an opinion from a competent attorney regarding the legality of such a plan before making a final decision to enter into it.

6140.7 DEFERRED COMPENSATION CONTRACTS/AGREEMENTS

Deferred compensation contracts are either treated as pensions or accrued for individually. If the deferred compensation contracts with individual employees, when taken together, are equivalent to a pension plan, then they are accounted for as a pension plan.

Other deferred compensation contracts which include, but are not limited to, such provisions as continued employment for a specified time, availability for consulting work, etc., should be accounted for individually on an accrual basis. The total amount of accruals when added together should equal no less than the present value of the benefits provided in the contract. Accruals should be made systematically over the active term of employment.

Some deferred compensation contracts pay periodic payments to retirees or their beneficiaries for life, with lump sum payments in the event of early death of one or all of the beneficiaries. If the benefits are payable for life, then the total liability should be based on the beneficiaries' life expectancies, rather than on the minimum amount payable in the event of early death.

6140.7.1 ACCOUNTING PROCEDURES FOR DEFERRED COMPENSATION CONTRACTS/ AGREEMENTS

The following example demonstrates the accounting procedures for a deferred compensation agreement:

Assume the credit union has entered into a deferred compensation agreement with an employee scheduled to retire in 5 years. The terms of the agreement call for the credit union to pay the employee, upon her retirement, or her beneficiaries, in the case of her premature death, $500 a month for 15 years.

In order to fund the deferred compensation amount at the end of the initial 5 years and for the subsequent 15 years, the credit union has decided to purchase an annuity. The credit union is the owner and beneficiary of the annuity. The annuity should be accounted for as a credit union investment consistent with guidelines provided in Section 6060 of this manual in an account titled, "Annuity to Fund Deferred Compensation Agreement".

Because this is not equivalent to a pension plan, the credit union should expense the cost of the deferred compensation over the remaining period of the employee's active retirement. The entries should be made each pay period (twice a month, in this example):

a) To accrue the amount of the deferred compensation expense ($692.30 per pay period x 26 pay periods per year for 5 years or $90,000):

Dr. -Other Compensation (Acct. No. 219)	$692.30	
Cr.-Accrued Employee Benefits (Acct. No. 852) or Other Accrued Expenses (Acct. No. 859)		$692.30

NOTE: The annuity purchased to fund the deferred compensation agreement should, in this case, provide a sufficient return to fund the $500 per month deferred compensation obligation of the credit union beginning at the end of five years plus $500 per month thereafter for the remaining 179 months (5 years x 12 months per year less 1st month).

The annuity (principal and interest) need not have grown to $90,000 by the end of the initial 5 years as long as funding (annuity cash flow) is sufficient to meet the $500.00 monthly expense from year six through twenty (15 years). The total accrual, however, must be $90,000 ($500 per month x 12 months x 15 years) over the next 5 years (the term of the employee's remaining active employment).

6140.7.2 REQUIRED DISCLOSURES FOR DEFERRED CONTRACTS/AGREEMENTS

Postretirement benefits such as deferred compensation agreements should be disclosed on the credit union's financial statements. The disclosure should include at least the following:

a) Description of employee groups covered and benefits provided,

b) Description of the accounting and funding policies used for the benefits.

c) Cost of the benefits included in net income for the period.

d) Effect of significant items that affect comparability of benefit cost for all periods presented.

6140.8 THE EMPLOYEE RETIREMENT INCOME SECURITY ACT OF 1974 (ERISA)

This Act was designed to give more protection to employees included under private pension plans and protection from the weaknesses and abuses in administering of these plans. The Act is also referred to as the Pension Reform Act of 1974. Prior to this legislation, the laws dealing with the creation and management of these private pension plans, and their assets were unclear and ineffective. A pension plan administrator could operate a plan according to his own judgment and intuition.

Fully encompassing minimum requirements for funding benefits were established in the passing of this new Act to protect the rights of employees. The requirements provide for:

a) Establishing standards of conduct, responsibility, and obligation for fiduciaries of employee benefit plans;

b) For appropriate remedies, sanctions, and ready access to the federal courts;

c) Requiring plans to vest the accrued benefits of employees with significant periods of service;

d) Requiring plans to meet minimum standards of funding; and

e) Requiring plan termination insurance.

Not all pension plans referred to in ERISA are required to meet the requirements stated above; however, every employee benefit plan (including individual retirement accounts and Keogh plans) must meet the disclosure and reporting requirements of Title I of ERISA. To aid in the understanding of this and other requirements, it is helpful to examine the definition of "employee benefit plan."

The term "employee benefit plan" is defined in ERISA to include two types of plans:

a) An employee welfare plan; and

b) An employee pension benefit plan, also called an employee pension plan. An employee plan may also be a combination of these two types, which are explained below.

    1) An employee welfare plan provides for medical, surgical or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment. A welfare plan can also provide for vacation benefits, training programs, day-care centers, scholarship funds or prepaid legal services.

    2) An employee pension benefit plan or pension plan is any plan maintained by an employer or employee organization that provides: (a) retirement income to employees, or (b) results in a deferral of income by employees for periods extending to the termination of employment or beyond.

The authorities responsible for the enforcement of ERISA are the Department of Labor (Labor), the Department of Treasury, through the Internal Revenue Service (IRS) and the Pension Benefit Guarantee Corporation (PBGC).

Regulations have been promulgated under the provisions of ERISA by Labor, IRS and PBGC, and overlap in many areas. Generally, the reporting and disclosure, participating and vesting, funding and fiduciary responsibility provisions of ERISA are administered by Labor. The IRS is also responsible for participation, vesting and funding standards, as well as prohibited transactions. The PBGC is responsible for plan termination insurance.

Administrators of private pension plans are now required to file annual reports with the Department of Labor that include a description of the plan, financial statements and extensive supporting schedules.

Credit unions should obtain competent outside assistance for additional information regarding eligibility, coverage, vesting and minimum funding standards. Because of its complexities that often require legal interpretation, we have not expanded our discussion of those requirements here. Credit union officials should ensure that the credit union's files contain a legal opinion that its plan complies with the provisions of this law.

6140.9 DEFINED CONTRIBUTION PLANS

A defined contribution plan specifies the contributions to be made to an individual employee's retirement account rather than the amount of retirement benefits the retiree is to receive.

The net pension cost for any period is the amount to be contributed by the credit union during that period, as required by the plan. If the plan requires contributions for periods after the employee retires or is otherwise separated from employment by the credit union, the estimated cost is to be accrued during the employee's service period with the credit union.

Credit unions having one or more defined contribution plans are required to disclose the following separately from their defined benefit plan disclosures:

a) A description of the plan(s), specifying which employee groups are covered by the plan, the basis for determining contributions to the plan, and the nature and effect of significant matters affecting comparability of information for all periods presented.

b) The cost recognized during the current period.

Note that the accounting treatment and the required disclosures are considerably less for defined contribution plans than those for defined benefit plans. Credit unions should consider not only the cost, but also the additional burden of accounting and required disclosures when considering the nature and kinds of retirement plans to offer their employees.

Note further that a pension plan having the characteristics of both a defined benefit plan and a defined contribution plan may be required to be accounted for as a defined benefit plan, especially some "target benefit" plans. Even though the amount contributed may be specified by the plan, if the "substance" of the plan is to provide a defined benefit, the accounting and required disclosures will be determined in accordance with defined benefit plans.

6140.10 PRESENTATION OF PENSION PLANS IN FINANCIAL STATEMENTS

A federal credit union which sponsors a defined benefit pension plan must disclose and report the following in its financial statements:

a) A full description of the pension plan, including the employee groups covered, type of benefit formula, funding policy, types of assets held and significant nonbenefit liabilities (if any), and the nature and effect of significant matters affecting comparability of information for all periods presented.

b) The amount of net periodic pension cost for the period detailing the separate amounts for each of the following:

   1) service cost component;

   2) interest cost component;

   3) actual return on plan assets for the period; and

   4) net total of other components.

c) A schedule reconciling the funded status of the plan with amounts reported in the employer's statement of financial position, showing separately:

   1) The fair value of plan assets.

   2) The projected benefit obligation, separately identifying the accumulated benefit obligation and vested benefit obligation.

   3) The amount of unrecognized prior service cost.

   4) The amount of unrecognized net gain or loss, including asset gains and losses not yet reflected in market-related values.

   5) The amount of any remaining unrecognized net obligation or net asset existing at the date of the initial application of Financial Accounting Standards Board Statement of Financial Accounting Standards Number 87.

   6) The amount of additional minimum liability equal to either: (a) the unfunded accumulated obligation plus any prepaid pension cost; (b) the unfunded accumulated benefit obligation reduced by any unfunded accrued pension cost; or (c) the amount of the unfunded accumulated benefit obligation.

   7) The amount of the net pension asset or liability that has been recognized in the employer's statement of financial position. This amount must be equal to the total of items (1) through (6).

d) The weighted-average assumed discount rate and, if applicable, the rate of compensation increase used in determining the projected benefit obligation, and the weighted-average expected long-term rate of return on pension plan assets.

e) If applicable, the amounts and types of securities of the employer and/or related parties that are included in plan assets, and the approximate amount of annual benefits of employees and retirees covered by annuity contracts issued by the employer and related parties. Also, if applicable, the alternative amortization method used for unrecognized prior service cost and the alternative amortization method used to reflect the substantive commitment of an employer to pay more employee benefits than its existing pension benefit formula indicates.

6140.11 SETTLEMENTS AND CURTAILMENTS OF PENSION PLANS AND TERMINATION BENEFITS

A settlement occurs when a credit union either makes a lump sum payment to its employees in exchange for their rights to receive the benefits specified by the plan, or when the credit union purchases a nonparticipating annuity to cover the same benefits.

Not all transactions constitute a settlement. While purchasing high-quality fixed income securities with principal and interest payment dates similar to the estimated retirement plan payments and dates may avoid or reduce certain risks associated with the retirement plan, such a transaction does not constitute a settlement. It does not meet the requirements of a settlement because it could (at the credit union's discretion) be reversed, it does not relieve the credit union of the primary responsibilities and liabilities of the plan, and it does not eliminate all significant risks related to the plan obligation.

Curtailments include the termination of employees' services earlier than expected, such as in a significant layoff or workforce reduction, and termination or suspension of a plan so that the credit union's employees do not earn additional defined benefits for their future services.

A settlement and a curtailment of a defined benefit plan may occur separately or together. If benefits to be earned in future periods are reduced (because of a significant workforce reduction, for example) but the plan remains in effect otherwise, a curtailment has occurred, but a settlement has not. If a credit union purchases a nonparticipating annuity for vested benefits and continues to provide benefits for future services as defined in the same plan or in a successor plan, a settlement has occurred, but a curtailment has not. If a plan is ended (the plan obligation is settled and the plan is discontinued) and if it is not replaced by a successor defined benefit plan, a settlement and a curtailment have occurred.

6140.11.1 ACCOUNTING FOR SETTLEMENTS OF DEFINED BENEFIT PENSION PLANS

The maximum gain or loss credit unions may recognize in earnings when a pension obligation is settled is the unrecognized net gain or loss, plus any remaining unrecognized net asset on the books at the date of the settlement and recognition of such on the books. Included in that maximum amount is any gain or loss first measured at the time of settlement.

If the credit union settles the entire projected benefit obligation, the maximum amount (the amount referred to in the paragraph immediately above) is to be recognized in the credit union's earnings as a gain or as a loss, as applicable. If only a part of the obligation is settled, the credit union is to recognize only a pro rata portion of the maximum amount (as a gain or as a loss) in earnings equal to the percentage reduction in the projected benefit obligation.

If the cost of all settlements, cash, the amount paid for nonparticipating settlement annuities, or the amount paid for participating annuities less the amount attributed to the cost to the sum of the service cost and interest cost components of net periodic pension cost for the plan for the year, gain or loss recognition is allowed, but is not required. However, the accounting policy adopted by the credit union is to be applied consistently from year to year.

6140.11.2 ACCOUNTING FOR DEFINED BENEFIT PLAN CURTAILMENTS

If a credit union has an unrecognized prior service cost associated with years of service which are not expected to be rendered as the result of a curtailment, it is recognized in a loss in current earnings. If, for example, a curtailment results in a reduction of half of the remaining future years of service of a credit union's employees (as of the date of a prior plan amendment) who were expected to receive benefits under the plan, then the loss associated with the curtailment is half of the remaining unrecognized prior service cost related to that plan amendment.

A credit union's projected benefit obligation may be decreased (resulting in a gain) or increased (resulting in a loss) as a result of a curtailment, to the extent that:

a) Such a gain exceeds any unrecognized net loss (or the entire gain, if an unrecognized net gain exists), as a curtailment gain.

b) Such a loss exceeds any unrecognized net gain (or the entire loss, if an unrecognized net loss exists), as a curtailment loss.

A credit union having any remaining unrecognized net asset existing at the date of recognition of a curtailment is to recognize a net gain, and this gain is to be combined with the unrecognized net gain or loss arising subsequent to the recognition of the curtailment.

If a credit union's recognition and accounting for a curtailment (as described above) results in a net loss, it is to recognize the loss in earnings when it is probable that a curtailment will occur and the effects described are reasonably estimable. If such recognition and accounting results in a gain, the effects of that gain are not to be recognized until the curtailment actually takes place.

6140.11.3 DISCLOSURE AND FINANCIAL STATEMENT PRESENTATION FOR SETTLEMENTS AND CURTAILMENTS OF PENSION BENEFITS AND TERMINATION BENEFITS

A credit union which recognizes a gain or a loss as described above is to disclose the following:

a) A description of the nature of the event(s), or what happened, and

b) The amount of gain or loss recognized resulting from the above described event(s).

Obtain advice from an independent accountant as to whether these items should be reported as Extraordinary Items.

6140.11.4 TERMINATION BENEFITS

A credit union may provide termination benefits to its employees. These benefits may be either 4 special termination benefits" offered for a short time, or they may be "contractual termination benefits" to be paid if a specific event occurs, such as a layoff or the reduction of a significant portion of a credit union's workforce.

A credit union offering special termination benefits to its employees is to recognize a liability and a loss when its employees accept the offer, and the amount can be reasonably estimated. A credit union offering contractual termination benefits is to recognize a liability and a loss when it is probable that its employees will be entitled to benefits and the amount can be reasonably estimated.

A credit union may offer termination benefits in various forms, including lump-sum payments, periodic future payments, or both. A credit union may pay these benefits directly from its assets, from an existing pension plan, from a new benefit plan, or a combination thereof.

A credit union is to include lump-sum payments and the present value of expected future payments in the cost of termination benefits it recognizes as a liability and as a loss. Note that a situation involving termination benefits may also involve a curtailment, to be accounted for as described above.

6150 SHARE DRAFTS

6150.1 DEFINITIONS

a) *Share Draft* means a negotiable or nonnegotiable draft used to withdraw shares from a share draft account.

b) *Payable through bank* means a bank that has been designated to make presentment of a share draft to the federal credit union for payment.

c) *Payable at bank* means a draft drawn on the credit union that is payable at any correspondent or Federal Reserve Bank. It is payable when it falls due out of any funds of the maker or acceptor. The bank is expected to make payment without consulting the credit union. In this situation the draft is endorsed, "Payable at any bank" and it bears the routing and transit number of the credit union.

d) *Truncation* means the original share draft is not returned to the member.

e) *Share Draft Account* means an account from which the holder is authorized to withdraw shares by means of a negotiable or transferable instrument or other order.

f) *MICR* stands for Magnetic Ink Character Recognition and refers to the numbering printed in magnetic ink at the bottom of each share draft.

6150.2 ESTABLISHING A SHARE DRAFT PROGRAM

The board of directors should determine, prior to implementing the share draft program, that the member's use of share draft is economically and operationally feasible for the federal credit union. This should be supported by written operational and program specifications that will be available at the credit union's principal office.

The share draft program should provide for truncation, additional surety bond coverage, and retaining copies or photo reproductions of paid share drafts (or other orders of withdrawal) on file for a period of 5 years, or as required by applicable state law.

6150.2.1 EXPERIMENTAL SHARE DRAFT PROGRAM

The board of directors may design a share draft program that provides for an experimental share draft program. This program should include terms and conditions that restrict the number of share draft accounts for a period which should not exceed 1 year. The advertising and disclosure requirements of Section 701.35 of the National Credit Union Administration Rules and Regulations are applicable.

A share draft program may also provide for participation in guarantee arrangements. Share drafts must compete equally with instruments issued by other financial institutions. When the practice of other financial institutions in the local market place so requires, federal credit unions must be in a position to guarantee share drafts through the use of a guarantee card or other method.

This must be done in such a manner that third parties, without cumbersome and sometimes unsuccessful processes, may be immediately satisfied that a share draft is guaranteed when it is accepted for payment. A share draft program may provide for guarantee arrangements provided the board of directors adopt a Standard Bylaw amendment to Article III, Section 5(a) of the Federal Credit Union Bylaws.

Refer to the booklet entitled "Federal Credit Union Standard Bylaw Amendments and Guidelines." That particular bylaw amendment provision will effectuate an absolute guarantee of a share draft by a federal credit union. If it were not adopted, a federal credit union would have the right to require up to 60 days notice of intent to withdraw, thus preventing an absolute guarantee. If a federal credit union has adopted this Federal Credit Union Bylaw Amendment it may issue guarantee cards which, on presentment to a third party, will assure payment of a share draft.

6150.3 GUIDELINES ON THE USE OF PAYABLE-THROUGH SHARE DRAFTS IN A FEDERAL CREDIT UNION'S GENERAL DESCRIPTION OF OPERATIONAL FLOW

Share drafts may be used as a part of the remote funds withdrawal procedures available to credit union members. Under this program, the following actions take place during its operation.

a) The member establishes a share draft account by signing a share draft agreement.

b) The credit union then provides the member with a book or books of share drafts.

c) The member writes a draft and presents it to a merchant, bank or other party for purchase of goods or services or draws a draft for cash.

d) The payee ordinarily presents the drafts received to his own bank. (Deposits the drafts with other receipts.)

e) The payee's bank forwards the draft through bank clearing channels for presentment to the payable-through bank.

f) The payable-through bank receives the draft and makes provisional payment subject to payment or dishonor by the credit union.

g) The payable-through bank upon receipt of the draft presents the information on the draft to the credit union. Normally the information on the share draft is converted to an electronic medium at this point (magnetic tape) and is transmitted to the credit union for payment or dishonor. The information may also be transmitted directly to the credit union's EDP Supplier.

h) The credit union then approves payment and posts the share withdrawal to the member's account.

i) The member receives a periodic statement of account(s) which identifies the drafts paid during the period and payments to the credit union.

6150.4 DESCRIPTION OF A SHARE DRAFT UNDER A PAYABLE-THROUGH SYSTEM

The share draft is usually made payable to cash or identifies the payee preceded by the words "pay to" or "pay to the order of." Each share draft also identifies the member's name and address, the name of the payable-through bank (preceded by the wording "paying through") and the name of the credit union. The share draft should contain the following information printed in accordance with the standards required for Magnetic Ink Character Recognition (MICR):

a) The payable-through bank's routing and transit number which provides the identification required for routing share drafts to the payable-through bank.

b) The share draft account number which provides the necessary information to charge the appropriate members' account.

c) The number of the draft which provides the information necessary to reconcile the share draft account without returning the draft to the member.

6150.5 SHARE DRAFT AGREEMENT

A share draft agreement that outlines both credit union and member responsibilities should be signed by each member desiring to use share drafts. The agreement should outline the credit union's and member's rights and agreement, such as approved methods of withdrawal, obligations and liability of the credit union and the members, provisions for service charges, overdrafts, accessing lines of credit, ultimate liability on guaranteed share drafts, if any, and a specified time period for the member to object to items reflected on his periodic statement of account.

6150.6 SHARE DRAFT ACCOUNT

The share draft account established by the share draft agreement should be used to record all share drafts which the member writes and which the credit union pays. The share drafts should be posted to the account as of the date the bank makes provisional or actual payment or receives the draft. Normally the credit union is notified of the drafts received by the payable-through or payable at bank on the day after the payable at or payable-through bank receives the drafts.

Statements of the share draft account should identify the date of withdrawal or share payment, the amount of the withdrawal or payment and the number of each draft paid. The serial number will assist the member in reconciling his account with his records.

6150.7 SHARE DRAFT ACCOUNT OVERDRAFTS

At the time a credit union receives a share draft which overdraws a share draft account the FCU has several options open to handling the situation:

a) The draft may be returned to the payable through or payable at bank as not paid for lack of sufficient funds. If this action is taken, it must be done within the time limits permitted the payable-through or payable at bank for returning items through the bank clearing systems to the payee.

b) The draft may be accepted pending receipt of payment from the member to cover the overdraft. The credit union needs to advise the member by telephone of the overdraft and will request that the member deposit sufficient funds to cover the draft prior to expiration of the time limits imposed for returning the draft. This procedure will normally involve only small overdrafts. The federal credit union will need to establish sufficient authorization procedures to provide internal control over this activity.

c) The draft may be accepted and an overdraft created as discussed and then cleared by a transfer from another share account from which the member is authorized to withdraw.

d) The draft may be accepted and the overdraft may be cleared by an advance from a line of credit special loan plan or other agreement established with the member. The line of credit agreement should be separate from the share draft agreement and must comply with the provisions of Part 701.21(c) of the NCUA Rules and Regulations. Authorization should be included in the Share

Draft Agreement for the credit union to transfer the amount of loan advance to the share draft account and should provide wording such as the following:

"In the event that any of the undersigned writes a share draft which would result in this share draft account being overdrawn, and if at that time any of the undersigned is eligible to receive advances from this credit union under the loan account referred to above, that share draft shall be deemed to be a request to the credit union for an advance under such loan account in multiples of $ sufficient to permit the credit union to honor such draft and credit the advance to the share draft account."

Under this procedure, a designated person will work from a listing of drafts which will overdraw share draft accounts. This listing should become a permanent part of the credit union's records. Additional conditions necessary for using this procedure involve: (1) persons signing this agreement must be members to insure that all persons who are parties to the agreement are eligible for a loan, and (2) notification of each overdraft should be forwarded to the members at the time it occurs. If, however, the credit union issues monthly statements, it may not be necessary to send overdraft notices if overdrafts are clearly indicated on the monthly statements. If an overdraft notice is issued, it should identify the draft overdrawing the share draft account, the date received and the amount. The method and timing of the notice will be dependent on the discretion of the board. It should not be less frequent than monthly, however.

All overdrafts occurring on the share draft account should be reflected on the statement of account as a debit balance. This procedure needs to be followed regardless of whether or not the overdraft is to be cleared by an advance from a loan account or from another share account. Such a procedure may not be needed for EDP systems which have the capability of preparing a list of drafts which will overdraw a share account if they are posted.

In these systems, the credit union officials are able to take action to prevent the occurrence of an overdraft by posting an advance from a line of credit to the share account or making a transfer from another share account prior to posting the draft which would have overdrawn the account. Should a credit union have this capability, it should be used in lieu of posting the proceeds of a loan or other funds to the account.

The member will receive notification of the overdraft at the time it occurs regardless of how it is cleared. The draft which would have created the overdraft situation should be posted to the share account on the same day as the line of credit advance or share transfer.

6150.8 DRAFT VERIFICATION PROCEDURES

Since the credit union officials do not actually review share drafts received for payment to determine if the member signed the draft presented, the procedures to verify the authenticity of the transaction depend upon the member's review of their periodic statement for unauthorized drafts. Since each member may receive notice of all overdrafts when they occur, the member can have the opportunity to notify the credit union of any unauthorized drafts which may have caused the overdrafts.

When a credit union receives notice of an unauthorized draft, the original draft or a copy of the original draft is retrieved for comparison against the signature card on file at the credit union's office. It is up to the officials of the credit union to determine whether or not the forged draft is to be returned to the payee for reimbursement. Insurance is available to protect the credit union from loss due to forged drafts. The board of directors will determine whether or not this type of insurance is to be obtained. In any event, insurance coverage for forged drafts and the amount necessary is a matter for the board of directors to determine.

6150.9 SETTLEMENT ACCOUNT

In order to make settlement for drafts which are provisionally paid by a payable-through bank or payable at bank, FCUs normally maintain a deposit account in the payable-through bank or payable at correspondent or Federal Reserve Bank. Other alternatives for settlement include use of an investment account, such as an account with ICU, a savings and loan association or Corporate Central Credit Union through which funds are transferred to the payable-through bank via preauthorized agreements. The payable-through bank writes drafts against the account. The payable through bank may accept drafts in an account receivable clearing status and at the end of each day draw a draft against the credit union's demand deposit in a bank where the credit union does business. This method may be used where the payable-through bank is not an acceptable depository under Section 107(8) of the Federal Credit Union Act.

6150.10 STOP PAYMENT PROCEDURES

Federal credit unions using a share draft program must provide their members with the ability to stop payment on share drafts which they do not wish to pay because of loss or theft of the draft.

6150.11 DRAFT CASHING PROGRAMS

Federal credit unions establishing share draft programs may desire to make arrangements with local banks or other financial institutions to cash share drafts under the condition that the credit union provide authorization for each draft cashed. Credit unions becoming involved in this activity must assure that the authorization is recorded on the member's share draft account at the time it is given.

6150.12 SERVICE CHARGES AND FEES

Federal credit unions offering share drafts to their members may charge periodic fees or service charges to their members using share drafts. Charges may be assessed for distribution of interim statements, processing stop payment orders, overdrafts, obtaining copies of paid drafts for a member, and for the actual cost of the blank share drafts furnished to each member.

6150.13 INTERNAL SHARE DRAFT ACCOUNT

A federal credit union should not establish its own share draft account. The existence of a share draft account presupposes the existence of an account representing an equity of ownership interest in the credit union. In effect, a federal credit union would be redeeming its shares by using a share draft account.

What is actually desired is the ability of a federal credit union to issue drafts drawn against its assets. A federal credit union has been permitted in the past to draw drafts upon itself. The particular type of permissible draft would be the functional equivalent of a cashier's check which is drawn by a bank against itself. The bank is both the drawer and the drawee of the instrument. It becomes the bank's primary obligation and constitutes its written promise to pay on demand. Naturally, the credit union must retain its financial ability to honor the drafts.

Treasurer's Drafts

A federal credit union can issue a draft (Treasurer's Draft) that is drawn upon itself. The draft may bear the credit union's own routing and transit numbers and thus would be made payable at its Federal Reserve or correspondent bank where a Federal Reserve deposit account is maintained. Drafts paid would be recorded as a withdrawal from the deposit account in Other Shares, Deposits, and Certificates (Account No. 746).

6150.14 USE OF SHARE DRAFTS

All individual or corporations that are members of any federal credit union that provides for the establishment of share draft accounts, are eligible for share draft accounts. This includes organization of such persons who are members. It also includes federal credit unions that are members of corporate central federal credit unions. In addition, nonprofit organizations who are not members and are operated primarily for religious, philanthropic, charitable, educational, or other similar purposes may establish share draft accounts in low income credit unions.

6150.15 NEEDED OPINIONS OF LEGAL COUNSEL

The National Credit Union Administration Board advises credit unions to obtain a written opinion of counsel assuring that the particular share draft program undertaken by any given credit union not only conforms with federal law and regulation, but also any state law requirements or other requirements, such as clearinghouse rules for those credit unions choosing to use their own routing and transit numbers, the "payable at" method.

6150.16 FEDERAL RESERVE REGULATION D

Federal credit unions that offer share drafts may be subject to Federal Regulation D. This regulation is known as the Monetary Control Act of 1980 and requires depository institutions to maintain reserves against their transaction accounts, and nonpersonal time deposits. With respect to credit unions, "depository institutions" means any credit union that is insured by, or is eligible to apply for insurance with, the National Credit Union Administration. For purposes of Regulation D, share drafts are considered to be a transaction account.

Refer to Section 5240 in this Accounting Manual for a complete listing of transaction accounts and nonpersonal time deposits. Section 5240 also contains a discussion of the computation and reporting requirements for Federal Reserve Regulation D.

6150.17 FEDERAL RESERVE REGULATION CC

All federal credit unions which offer share drafts are subject to Federal Reserve Board Regulation CC (Regulation CC). In addition, all other federal credit unions are subject to Subpart C of Regulation CC which governs the rules to expedite the collection and return of checks by banks, including the standards governing the endorsement of checks for processing through banks. Subparts A and B of Regulation CC, apply only to share draft accounts called “transaction accounts.” Primarily, these two subparts contain definitions of terms and requirements regarding the availability of funds from deposits in these transaction accounts, the disclosure of credit union policies on the availability of funds, accrual of interest on these deposits, establishment of internal controls and an annual audit program on the procedures followed, and the establishment of a staff training program in the credit union to insure compliance with the board’s policies.

6160 TREASURY TAX AND LOAN ACCOUNTS

Credit unions are eligible to be designated as Treasury Tax and Loan (TT&L) depositories. Authority to become depositories is set forth in Section 701.37-1 of the NCUA Rules and Regulations. Application procedures and requirements for designation as a TT&L depository are set forth in the Department of Treasury Regulations.

There are two types of accounts in which a credit union may participate:

a) TT&L Remittance Account-an account, the balance of which is subject to the right of immediate withdrawal, established for receipt of payments of Federal taxes and certain United States obligations.

b) TT&L Note Account-an account subject to the right of immediate call, evidencing funds held by depositories electing the note option under applicable U.S. Treasury Department Regulations.

After the Department of the Treasury has designated a federal credit union as a Treasury tax and loan depository, the credit union should establish General Ledger Account No. 736, “Treasury Tax and Loan Remittance.” Funds in this account are not eligible for dividends.

Funds held in the federal credit union’s TT&L note account should bear interest at a rate specified in the Department of the Treasury Regulations and are not considered borrowings for purposes of Section 107(9) of the Federal Credit Union Act.

For share insurance purposes, funds in the TT&L Remittance Account and the TT&L Note Account should be considered public unit funds and as such are insured up to a maximum of $100,000 in the aggregate. The share insurance premium paid should include a premium equal to one-twelfth of 1 per centum of the total amount of funds in the TT&L Remittance Account and the TT&L Note Account at the close of the preceding insurance year.

A federal credit union may pledge specifically identified assets as collateral for TT&L Remittance and Note Accounts and may enter into such custodial arrangements as may be necessary to meet Department of Treasury requirements for collateral on TT&L accounts.

Federal credit unions are also eligible to act as a Depository or Financial Agent of the U.S. Government under the provisions of 31 CFR 203 and maintain Treasury General Accounts and Treasury Time Deposit-Open Accounts in accordance with Section 701.37-2 of the NCUA Rules and Regulations. The sum of these accounts should not exceed 20 percent of the total shares of the credit union, or $1.5 million, whichever is greater.

Detailed Entries:

Deposits into TT&L accounts should be recorded as a debit to "Cash" (Account No. 731) and a credit to "Public Unit Shares" (Account No. 910). Withdrawals should be recorded as a debit to Public Unit Shares and a credit to Cash.

6170 PUBLIC UNIT ACCOUNTS

Under the authority of Section 107(6) of the Federal Credit Union Act, federal credit unions can receive public funds. The authorized sources of public funds, and the insurance of these funds, are defined in Section 745.10 of the NCUA Rules and Regulations. If funds are received from more than one public unit, separate ledgers shall be maintained for each unit. For accounting purposes, public funds will be entered in the General Ledger under Shares-Public Unit Accounts, Account No. 910.

6180 SECONDARY CAPITAL ACCOUNTS FOR LOW INCOME CREDIT UNIONS

Federally insured credit unions designated as low-income are authorized to establish secondary capital accounts. The increased capital is intended to enable those credit unions to support greater lending and improve other financial services for the limited income groups and communities they serve. Certain restrictions are placed on these accounts, foremost among them is that the accounts may be *offered only to organizational investors*, not to natural person members or other natural person investors. Other key restrictions are:

- The accounts are not insured by the NCUSIF or any other government entity, and may not be offered as share accounts. They will take the form of subordinated debt.

- The funds in the accounts must be available to cover losses, after reserves and undivided earnings, but prior to liquidation.

- The accounts must have a minimum maturity of 5 years.

- The accounts may not be used as security on other obligations of the account holder.

- The accounts will not "carry over" as secondary capital in the event of merger into a credit union that is not low-income designated.

A declining scale for the capital value of accounts with less than 5 years remaining maturity has been established. All funds, however, will continue to be at risk to cover losses that exceed reserves and undivided earnings. Accounts with remaining maturities of at least:

- 4 years, but less than 5 years are counted as capital at 80 percent of face value;

- 3 years, but less than 4 years are counted as capital at 60 percent of face value;

- 2 years, but less than 3 years are counted as capital at 40 percent of face value;

- 1 year, but less than 2 years are counted as capital at 20 percent of face value; and

- less than one year remaining maturity will be counted as capital at 0 percent of face value.

A disclosure and acknowledgment must be provided and executed by an authorized representative of the account holder. State-chartered, federally insured credit unions may establish these accounts in accordance with the terms and conditions authorized for federal credit unions and to the extent they are not inconsistent with applicable state law, regulation, and accounting requirements.

A regulatory accounting position (RAP) has been taken to establish these accounts and to recognize them as secondary capital. These accounts are subordinated debt and the account holder does not have voting or ownership rights. Credit unions should record the amount of secondary capital in the equity section of the balance sheet, although any secondary capital that has a remaining maturity of less than 5 years will be split into capital and liability components based on a sliding scale. To be consistent with generally accepted accounting principles (GAAP), the credit union's outside auditor may recognize accounts established as secondary capital as subordinated debt, and for financial statement presentation purposes, may reflect the entire balance in these accounts in the liability section of the balance sheet.

Credit unions must adopt a written plan for use of the funds in the accounts and subsequent liquidity needs to meet repayment requirements upon maturity. The credit union should consider reasonableness and with risk assessment in mind.

The secondary capital accounts may not be established as share accounts and, therefore, will be considered a form of subordinated debt, in effect a borrowing. In most cases of borrowed funds, the stated interest rate is guaranteed contrary to dividends on share deposits for credit unions which are limited to the amount of funds available from earnings, both current and accumulated. The credit union should consider its ability to meet the interest payment obligation in light of its current and accumulated earnings. Interest payable on these accounts must be accrued at least monthly. The credit union should consider the effect on regular members' dividends when setting the interest rate or index for these accounts.

Section 107(9) of the Federal Credit Union Act limits a credit union's borrowing to 50 percent of its paid-in and unimpaired capital and surplus. The amount held in secondary capital accounts held by low-income credit unions is to be included in total borrowings for purposes of this limitation. Secondary capital accounts, plus any other borrowings by the low-income credit union will not exceed the 50 percent limit.

Part 705 of the NCUA Rules and Regulations addresses the Community Development Revolving Loan Program for Credit Unions. A credit union participating in the program may receive up to $300,000 in the form of a loan. A matching requirement encourages credit unions to develop a permanent source of *member shares* within one year of loan approval.

Accounts established as secondary capital by low-income designated credit unions may not be used as a source of matching funds for this program. First, secondary capital is not a *member share* and second, the regulation requires that the credit union maintain the increase in the total amount of *share deposits* for the duration of the loan from the program. These accounts "may not be offered as share accounts."

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